CURRENT EXCHANGE RATE RELATIONSHIP OF THE U.S. DOLLAR AND THE JAPANESE YEN

HEARING

BEFORE THE

SUBCOMMITTEE ON TRADE

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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CURRENT EXCHANGE RATE RELATIONSHIP OF THE U.S. DOLLAR AND THE JAPANESE YEN

TUESDAY, NOVEMBER 30, 1982

House of Representatives,
Committee on Ways and Means,
Subcommittee on Trade,
Washington, D.C.

The subcommittee met at 10:08 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Sam M. Gibbons (chairman of the subcommittee) presiding.

[Press releases announcing the hearing follows:]

[Press release No. 36 of Monday, Nov. 22, 1982]

The Honorable Sam. M. Gibbons (D-Fla.) Chairman, Subcommittee on Trade, Committee on Ways and Means, U.S. House of Representatives, Announces Hearings on the Current Exchange Rate Relationship of the U.S. Dollar Vis-a-Vis the Japanese Yen, December 1, 1982

The Honorable Sam M. Gibbons (D-Fla.), Chairman of the Subcommittee on Trade of the Committee on Ways and Means, U.S. House of Representatives, today announced that the Subcommittee will hold a one-day hearing on December 1, 1982, on the current exchange rate relationship of the United States dollar vis-a-vis the Japanese yen. The hearing will be held in room 1100 Longworth House Office Building, beginning at 10:00 a.m.

During Subcommittee hearings in late September regarding the U.S. automobile industry and H.R. 5133, The Fair Practices in Automotive Products Act, many witnesses cited the current exchange rate relationship of the U.S. dollar and the Japanese yen as a significant factor affecting competitiveness of U.S. products. In recent years, the yen has depreciated significantly against the U.S. dollar—by some calculations as much as 40 percent in the last four years. The result of this depreciation has been a significant increase in the competitiveness of Japanese relative to U.S. exports. The Trade Subcommittee feels that this relationship is important to overall U.S. trade performance, but that it has not yet been fully considered in this light. The purpose of the announced hearing will be to discuss the causes and effects of the exchange rate relationship, and its implications for U.S. trade policy.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Requests to be heard must be received by telephone to Harriett Lawler [telephone (202) 225-3627] by noon, Monday, November 29, 1982. The request should be followed by a formal written request addressed to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Room 1102 Longworth House Office Building, Washington, D.C. 20515.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Subcommittee are required to submit 75 copies of their prepared statements to the full Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearances.

Each statement to be presented to the Subcommittee or any written statement submitted for the record must contain the following information:

1. The name, full address, and capacity in which the witness will appear (as well as a telephone number where he or his designated representative may be reached);

2. A list of any clients or persons, or any organization for whom the witness appears; and

3. A topical outline or summary of the comments and recommendations in the full statement.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Persons submitting a written statement in lieu of a personal appearance should submit at least six (6) copies of their statement by the close of business December 10, 1982, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may submit 50 additional copies for this purpose if provided to the Committee during the course of the public hearing.

[Press release No. 37 of Wednesday, Nov. 24, 1982]

POSTPONEMENT OF SUBCOMMITTEE ON TRADE HEARING ON THE CURRENT EXCHANGE RATE RELATIONSHIP OF THE U.S. DOLLAR VIS-A-VIS THE JAPANESE YEN

The Honorable Sam M. Gibbons (D-Fla.), Chairman of the Subcommittee on Trade, Committee on Ways and Means, U.S. House of Representatives, today announced the postponement of a previously announced one-day hearing. In Subcommittee press release number 36, plans for a hearing had been announced on the current exchange rate relationship of the United States dollar vis-a-vis the Japanese yen.

A new date and time for the hearing will be announced shortly.

[Press release No. 38 of Wednesday, Nov. 24, 1982]

THE HONORABLE SAM M. GIBBONS (D-FLA.), CHAIRMAN, SUBCOMMITTEE ON TRADE, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES HEARINGS ON THE CURRENT EXCHANGE RATE RELATIONSHIP OF THE U.S. DOLLAR VIS-A-VIS THE JAPANESE YEN, NOVEMBER 30, 1982

The Honorable Sam M. Gibbons (D-Fla.), Chairman of the Subcommittee on Trade, Committee on Ways and Means, U.S. House of Representatives, today announced that the Subcommittee will hold a one-day hearing on November 30, 1982, on the current exchange rate relationship of the United States dollar vis-a-vis the Japanese yen. The hearing will be held in room 1100 Longworth House Office Building, beginning at 10:00 a.m. Plans for the hearing had been announced previously in Subcommittee press release number 36.

Chairman GIBBONS. Good morning.

As everyone knows, this is a meeting of the Trade Subcommittee of the Ways and Means Committee. The purpose of this hearing is to discuss one factor of trade, and that is on the financial end, the relationship of floating currencies to the marketplace, a very important part of the entire trade picture. It is an area that, as we get more and more used to floating currencies, we will have to pay a great amount of attention to.

Today our public hearing is going to focus on the exchange rate relationship of the United States dollar vis-a-vis the Japanese yen.

During our hearings in September on the domestic content bill, many of our witnesses mentioned the current yen/dollar rate as a factor affecting the competitiveness of the U.S. products.

The Japanese yen has fallen in value relative to the U.S. dollar in recent years from a high in 1978 of 175 yen per dollar to a low of 275 yen per dollar this fall.

The result of this significant depreciation of the yen has been a substantial increase in the competitiveness of Japanese goods here, in Japan, and in third country markets and a corresponding lack of competitiveness of our goods, not only in Japan, but in third country markets around the world.

We will discuss today the causes of these exchange rate fluctuations, their effects on U.S. products, and the implications for U.S. trade.

Our first witnesses will be a panel consisting of Timothy Elder of Caterpillar Tractor Co., Mr. Peter G. Peterson, chairman of the board of Lehman Brothers, Kuhn, Loeb, Inc., and Mr. Fred Bergsten, director of the Institute for International Economics.

Mr. Peterson is currently on his way here from the airport.

Our lead witness is from the Caterpillar Co. He didn't fare nearly as well. We received a phone call from Mr. Morgan saying he had been fogged in back in Illinois, so he has a substitute here.

Why don't we hear first from Mr. Elder, speaking for the Caterpillar Co., and then Mr. Bergsten and then we will go to Mr. Peterson whom I hope will be here from the airport at that time.

STATEMENT OF LEE L. MORGAN, CHAIRMAN, TASK FORCE ON INTERNATIONAL TRADE AND INVESTMENT, THE BUSINESS ROUNDTABLE, AS PRESENTED BY TIMOTHY ELDER, WASHINGTON REPRESENTATIVE, CATERPILLAR TRACTOR CO.

Mr. **Elder**. Mr. Chairman, members of the committee, let me extend the apologies for Mr. Morgan who has been unavoidably delayed in Peoria.

Our comments this morning are reflective of the views of Caterpillar Tractor Co., as well as the Business Roundtable Task Force on International Trade and Investment.

We appreciate the opportunity to appear before you this morning and to discuss the very important yen/dollar question.

We will be joined shortly, as the chairman indicated, by Mr. Peterson, chairman of the board of Lehman Brothers and the views which Mr. Peterson and I will be expressing are shared by a great number of our colleagues in the business community.

We believe strong action must be taken to address the yen/dollar problem.

Mr. Chairman, we would like to get right to the point.

In our view the problem facing American business as a result of the misalignment in the exchange rate between the dollar and the yen is the single most important trade issue facing the United States today.

The news from the world of trade has been pretty bleak of late. The U.S. trade deficit for 1982 is now projected to reach $42 billion and administration officials are talking about a $75 billion deficit next year.

From Geneva reports about the GATT ministerial were not very positive. A recurring theme is that the trade problems of the world are so great that a current of discontent pervaded the meeting.

Closer to home, Congress has on its agenda consideration of domestic content legislation that is probably the most protectionist piece of legislation proposed in this body during the last decade.

Large U.S. trade deficits, protectionism, bankrupt trade talks, these are the reasons responsible American policymakers must act to make sure the long-nurtured world trading system does not collapse.

What we are looking for today in other conversations we are holding with U.S. policymakers is a commitment you will actively pursue remedies to the imbalance in the yen/dollar relationship so American companies can compete fairly against their counterparts in the United States as well as third world countries.

Mr. Chairman, we believe—and a great many people agree with us—the undervalued yen is the root cause of severe economic problems. Trade frictions tend to manifest themselves in bilateral, sectoral ways. Certainly serious sectoral problems exist and we don't wish to diminish their importance, but we maintain the undervalued yen problem is pervasive.

It is a problem that affects nearly all sectors of the world marketplace and thereby all companies that face Japanese competition.

It isn't a new problem; it is a recurring problem.

There is no serious debate whether the yen is undervalued relative to the dollar. We haven't heard any real arguments to the contrary, even from the Japanese. What is less clear is why the yen is undervalued and there are many theories.

In our view, the problem is systemic. That is, the reasons lie deep within the Japanese system.

The undervalued yen is not the result of isolated nations, but it is the natural consequence of an economic and political structure designed to, among other things, maintain high employment and low interest rates.

It is a system that controls capital flows and foreign reserves. Let's look at the serious problems that are caused by the undervalued yen.

American companies are losing sales to Japanese firms not because of cost, quality, or service, but because of the unearned price advantage due to the undervalued yen.

The Caterpillar experience is illustrative of this problem.

On a recent Middle Eastern transaction, the Cat dealers' bid was $14 million. Both we and our dealer had already heavily discounted our price; in fact, cutting it to the break-even point.

Still, Kimatsu of Japan, our biggest competitor, underbid us by 19 percent by offering a price of $11.3 million.

At the time the yen was trading at 260 to the dollar. If it had been trading at 180 to the dollar, Kimatsu would have had to bid $16 million to get an equivalent amount of yen. That would have been 14 percent more than our bid.

We are convinced the artificially weak yen cost us that business.

In another recent incident, we were involved in a multimillion dollar bid for machines in Iraq. We quoted our products at our out-of-pocket costs. In other words, we quoted them at a loss, at a price we couldn't even cover our fixed costs with.

Kimatsu came in 37 percent below that and we lost the deal.

Let's look at the bottom line impact. Kimatsu's sales for the first half of this year rose 17 percent at the same time Caterpillar's sales fell 14 percent. Their export sales were up 47 percent, while our sales outside the United States were down 14 percent.

Kimatsu is a darned good company, but they are not that good of a company.

This artificial price advantage gives them the competitive edge they have used so masterfully.

Mr. Chairman, members of the committee, the implications of this problem are substantial. We are not just talking about the well-being of a company or two. We are talking about the continued vitality of the heavy industrial sector of the United States.

We are talking about the potential strength of the economic recovery which we all hope is on the way. We are talking about thwarting American industry's efforts to become more competitive by improving productivity and restraining wages and other costs. And, we are talking about the probability that severe pressures for sectoral protectionist legislation will remain in this country if the trade competitiveness problem is not addressed in a satisfactory way.

The problems are such that it is critical that the U.S. Government urgently consult and collaborate with the Japanese Government in a joint program to stimulate the move toward a stronger yen. We don't have time for studies of the problem; we don't have time for fundamental economic forces to work their will on the marketplace as some contend they will.

Where the survival of the industrial base of this country is at stake, we can't afford to do anything less than move quickly and aggressively to solve the problem. The yen is currently trading at 250 to the dollar. That is an improvement from a few weeks ago; but it still remains grossly undervalued.

Caterpillar economists, among many others, believe that a pro-equilibrium rate today would be in the 180 to 200 range. Many thoughtful Japanese agree with us. They acknowledge that the yen is substantially undervalued and that the implications are very important.

At the 19th annual meeting of the Advisory Council on Japan/United States Economic Relations in Japan earlier this year, a special statement was issued with this lead paragraph:

> Japanese and American businessmen agreed that the current misalignment of the yen/dollar exchange rate is one of the factors responsible for an unprecedented imbalance in the trade accounts between the two countries.

Mr. Morgan was fortunate enough to attend that meeting in Japan and discuss this problem at length with our Japanese hosts. It was good to hear them acknowledge that action was indeed needed.

Now, the time is ripe for an official U.S. approach to the Japanese, indicating a desire to work together toward a solution to the problem, to each side's long-term benefit.

The Japanese have just selected a new Prime Minister. That Prime Minister has said he wants to improve relations between his country and the United States.

We propose that we take him at his word and pose a fundamental question:

Help us eliminate the yen/dollar distortion so that our two countries can trade, compete, and otherwise interact on a positive basis.

It is our belief we will find the Japanese responsive to our request for serious cooperation.

The key to resolution of this problem is a joint program of the Government of the United States and Japan. Something as simple as a public acknowledgement by the two governments that they intend to work together to solve the problem would be beneficial. Beyond that we are not prepared today to lay out all the details that should be part of a joint United States/Japanese initiative on the yen, but let me mention a few possibilities that have to be considered.

First, Japanese measures to encourage capital inflows; measures to stimulate foreign investment in yen instruments in Japan; the attachment of a surcharge on Japanese manufactured goods, and conventional foreign exchange intervention techniques applied by the United States and other central banks.

In addition, measures to lower future U.S. interest rates which will greatly help the U.S. economy and possibly help reduce currency imbalances.

We suspect that Mr. Peterson, when he joins us, and others of the witnesses this morning, will elaborate on some of these and perhaps other elements, but allow me to reiterate once more that what we want as a long-term goal is a freely traded international yen.

If the United States cannot satisfactorily address this problem on its own, then we should consider bringing it to the attention of the International Monetary Fund.

Under article IV of the IMF, persistent increases in a member's foreign exchange reserves or prolonged use of capital controls for balance of payments purposes signal a need to review exchange rate policies.

We believe such a review is warranted.

Mr. Chairman, these are strong actions we are talking about, but when a patient is very ill, he can't be satisfied with a "take two aspirin and call me in the morning" approach.

This very ill economy and this very important yen/dollar problem requires strong medicine and they require it now. We fully understand that the executive branch must take the lead in pursuing any initiative like we have detailed this morning, but we believe there is an important role for Congress as well and that is part of the reason we are here today.

Congressmen, better than anyone else in this city, have close daily contact with businessmen, with workingmen of all descriptions, all around this country. You, better than anyone else, have the ability to convince President Reagan and his key advisers that this is a problem that is important to Americans; that it is a problem that deserves their serious attention and action.

The American business community has held high level discussions with the executive branch. We have told the administration that we need and expect its help.

Now, I suggest that you do whatever is within your ability to reinforce that message, stressing its importance and its urgency.

Mr. Chairman, with that, I would like to conclude my remarks and turn to Mr. Bergsten for his comments.

Chairman **Gibbons**. Thank you for your statement.

We will turn to Mr. Bergsten now.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. It is a pleasure to be here again, Mr. Chairman. You will recall that just over 2 months ago, when you were holding your hearings on the local content legislation, we did discuss this issue at some length.

What I tried to do in my statement today is update the discussion we had at that time, tried to quantify the magnitude of this very enormous problem facing the U.S. economy and U.S. trade; tried to discern what the causes of the problem are, and then suggest in a bit more detail what can be done about it.

Chairman GIBBONS. Mr. Bergsten, you are in a unique position to do that because you have served in our Government in high positions, particularly in the Treasury Department where this has been a primary responsibility. I am delighted to have you here this morning to help us with this problem.

Mr. BERGSTEN. Let me say at the outset I greatly appreciate those comments and also that I strongly support almost everything that Mr. Elder said.

I think the Business Council is to be greatly commended for its having recognized the urgency of this problem and brought it to the attention of policy officials in both the Congress and executive branch.

For some mysterious reason, the business community and labor unions in this country have never really recognized that much of the trade problem which so seriously affects them is due to these monetary elements.

Chairman GIBBONS. I remember you trying to persuade me of that a number of years ago.

Like most Americans that had very little experience with currency exchanges and how they work, I am glad you are here to expand on that.

Mr. BERGSTEN. Mr. Chairman, I am delighted to say I know you have learned. I am very pleased that the trading community itself has now recognized how central this is and that policy measures in this area, rather than destructive import controls or other trade measures, are the way to go to deal with so much of the problem.

Let me comment on the basis of my prepared statement in the three areas I mentioned.

The first point is to quantify the devastating impact on our economy, not just our trade balance, but our economy as a whole that is now being caused by the overvaluation of the dollar which, on a conservative estimate, clearly runs at least 20 to 25 percent against all currencies and more against the yen.

I document that in my paper.

Let me give you the impact of the situation on the U.S. economy. From the first quarter of 1981 through the third quarter of this year, the latest data we have available, U.S. net exports of goods and services have declined by over $22 billion in 1972 dollars—that is the formulation used in the GNP—and accounted for over three-quarters of the decline in our total GNP in this recession.

Chairman GIBBONS. Give me that again now?

Mr. **Bergsten**. These now are Commerce Department numbers, 1972 dollars, to avoid distorting——

Chairman **Gibbons**. Constant dollars?

Mr. **Bergsten**. Constant dollars to avoid distortion from inflation.

From the first quarter of 1981 to the third quarter of this year, the latest data available, total U.S. GNP declined about $29 billion over those seven quarters. That is the recession in current—in constant dollars.

Chairman **Gibbons**. $29 billion?

Mr. **Bergsten**. $29 billion in constant dollars.

During that same period, the decline in our trade balance was over $22 billion.

Now, there are some pluses and minuses. You can't add them all up in a simplistic way.

Chairman **Gibbons**. Excuse me. Let me interrupt.

Mr. Peterson has made it here. Mr. Peterson, we are glad to have you join us.

While Mr Bergsten goes ahead, you can be getting ready.

Mr. **Bergsten**. In short, you have got both an enormous decline in the trade balance in absolute terms and a decline which has been equal to three-quarters the total decline in our GNP over the last year and a half. That is far bigger than the slump in the housing industry; far bigger than the slump in the auto industry or, indeed, in consumer durables as a whole.

It is the biggest single factor in the recession.

To give some other indicators: In the third quarter of this year—and now I am shifting back to current dollars, the ones in the public press all the time—the merchandise trade deficit in the third quarter reached an all-time record high, an annual rate of $52 billion; and August, of course, was the worst trade month in our history.

What makes these numbers so surprising is that they have occurred despite the domestic recession and despite a big decline in oil imports.

Normally, when we have a recession, our trade balance improves sharply because the demand for imports drops along with the demand for everything else.

This time, in addition, oil imports, both in volume terms and in value terms, have declined very substantially.

So one would have expected a very marked improvement in the U.S. trade balance in 1982 given the underlying economics. Instead, we have had this dramatic deterioration and there can be only one explanation, the huge overvaluation of the dollar in the exchange markets.

Unfortunately, that is only the start of the story.

A variety of studies show that the U.S. trade balance tends to deteriorate over 1 year or about $3 billion for every percentage point loss in our price competitiveness in international trade.

If you figure conservatively the dollar is overvalued by about 20 percent, that means we could expect to lose $60 billion in trade balance by the time the effects play their way through.

Chairman **Gibbons**. Run through that again.

Mr. **Bergsten**. The analysis done in a number of quarters, both in and outside government, show that based on the historical record, our trade balance deteriorates by about $3 billion for every 1 percentage point deterioration in our international price competitiveness.

If our inflation rises faster than other people's with no change in exchange rates, we lose price competitiveness. If the dollar rises in value against other currencies, without our inflation being lower, we lose price competitiveness. What you have over the past 4 years is a rise in the dollar by a factor of about 30 percent; whereas, U.S. inflation has been roughly equal to that of our other trading partners.

So you have had a deterioration in our price competitiveness over the last 4 years on average against all countries, not just Japan, by about 30 percent.

I would say these statistical approaches are imprecise, and there was probably some dollar undervaluation back in late 1978. So conservatively I estimate the dollar is overvalued by at least 20 percent, but that is a conservative number.

If you take that 20 percent as being about right for the dollar overvaluation and apply to that the loss of $3 billion per percentage point deterioration, you get an expectation of about a $60 billion adverse swing.

Even in our $3 trillion economy, that is 2 percentage points off the GNP. As I indicated, we have already seen some of that.

Given the fact that the merchandise trade deficit was already about $30 billion before all this started back in 1980, one would expect to see the trade deficit approach $100 billion sometime within the next year or so; maybe not for a full year; maybe for a few quarters at annual rates; but it would get close to $100 billion or even beyond it.

Now we have, of course, a structural surplus in service items running about $35 billion now; but that means that the current account deficit clearly will go to at least $40 or $50 billion, which is three times greater than we have ever seen in the past.

So the story, I am afraid, is for a huge deterioration even larger probably than Deputy Secretary McNamar and CEA Chairman Feldstein mentioned publicly.

They talked of a $70–$75 billion trade deficit next year. It could be larger than that for some quarters or half years, with a big deterioration in the GNP. What that swing would do would be take one to one and a half percentage points off the GNP.

In the kind of slow-growing economy we expect anyway, that could negate any positive growth because of a deterioration in the trade balance. This translates to between one and two million job opportunities being lost because the overvalued dollar makes us less competitive. It is across the board, and given the parameters we use in relating jobs to trade, somewhere between 1 and 2 million job opportunities will be lost as a result of this further deterioration in our trade balance that can be expected in 1983.

The one other point to mention about the problem, particularly given the competence of this committee, is that over the postwar period, an overvalued dollar has been the strongest leading indicator of pressures for import controls for very understandable reasons.

Even Adam Smith and David Ricardo, when they outlined the original case for free trade, based it on several very important assumptions.

One of those assumptions was balance of payments equilibrium or, in today's terms, exchange rate equilibrium.

So the AFL-CIO has a point, and beleaguered American industries have a point when they come in and seek relief from the impact on their trade competitiveness of the international environment in which the United States finds itself.

I think they are wrong in seeking import controls—that is not the issue—but they are right to put it, as Mr. Elder and the Business Council are now doing: "The exchange rate must be gotten right."

If it does not, it is the same thing as having a tax on all our exports of 20 to 25 percent; it is the same thing as paying a subsidy of 20 to 25 percent on every import coming into the country when the pricing relationship between the dollar and other currencies is out of whack by that amount.

It is just like an import subsidy and an export tax.

We, therefore, jeopardize our competitive ability by that amount in doing it. It is quite natural, as happened in the early seventies and as is happening again—this time, of course, compounded by the high rates of unemployment—that you here on the committee get enormous pressures for trade controls because in large part, in my judgment, of a misaligned currency situation.

So far I have talked in aggregate terms.

Let me turn specifically to the yen which is the point of departure today. I would argue that the overvaluation of the dollar is most critical vis-a-vis the yen for both quantitative and qualitative reasons.

Quantitatively, the dollar/yen misalignment, I think, is more severe than the misalignment between the dollar and other currencies.

From that late 1978 base until early last month, the dollar had, in fact, risen by over 50 percent against the yen, as you mentioned in your opening comments: 175 to 275. That is a little over 50 percent.

In addition, U.S. inflation, though it has come down recently, has over that period run about 20 percentage points higher than Japanese inflation. So when you put the two things together—the dollar rising 50 percent in value against the yen and U.S. inflation being 20 percentage points more than Japanese—you find our price competitiveness vis-a-vis Japan has deteriorated by 70 percent in 4 years. So it can hardly be a wonder there is a crisis in United States-Japan economic relations and concerns of the type Caterpillar has experienced in terms of our competitive relationship with Japan.

The qualitative impact of the yen problem is, of course, severe because Japan is our biggest overseas trading partner. It is obviously also the major source of much concern, rightful concern in the United States about the competitiveness of both our basic industries and our futuristic industries, and so we worry more about our competition with Japan than about any other country, and a price relationship, a price distortion of this type is therefore critical in both qualitative and quantitative terms.

My bottom line on what needs to be done is identical to Mr. Elder's: The yen rate must strengthen to somewhere between 180 and 200 to the dollar and it must do so quickly. Most Japanese, as he said, agree that the yen needs to rise. Some would say 210 is enough, or 220 is enough, but everybody agrees that it needs to rise.

It should be noted that the yen has already risen by about 10 percent over the last month. It hit a low point of about 80 to the dollar in early November. It has now risen to about 250 to the dollar at the close yesterday.

One has to ask the question whether or not this strengthening of the yen that has already occurred will continue on its own sufficiently to deal with the problem. There are some reasons to believe that we are at least now headed in the right direction and may continue that way. Short-term U.S. interest rates have come down sharply, which has narrowed the gap to some extent, not as much as one would think but to some extent in interest rates between dollar and yen assets in real terms.

A second factor driving the exchange rate in the right direction is that the markets are now coming to be aware of this huge deterioration in the U.S. trade and current account positions I talked about. I flagged it over a year ago but now officials are talking about it and there is much greater perception in the market that these developments are going on. So the market is turning its attention to the outlook for a very sharp deterioration in the U.S. external position. That, of course, puts downward pressure on the dollar, upward pressure on the yen.

I think also the increased concern expressed here in the United States about the impact of the exchange rate on trade, the efforts of the Business Council, the efforts of this committee, and others, is also now bringing home to the Japanese the important linkage between the monetary and trade sides, how important it is to correct the monetary problem to avoid protectionist trade measures in this country, and I think it may already have persuaded them to take some moves to strengthen the yen; for example, talking to some of their big foreign investors—insurance companies, banks, others—to limit the outflow of capital from Japan to strengthen the yen. There certainly is evidence of that over the past few weeks. I think the message may be getting through.

So I think there is some reason to believe we are now headed in the right direction. However, I would also have to say there have been several false starts in the past when the yen and other currencies have started to strengthen only to fall back to and beyond their previous lows. Moreover, it is unclear whether market forces would push the yen far enough, maybe up to 240, but then peter out whereas that clearly would not be enough.

I would also submit, as Mr. Elder did, that we are in a race against time, that protectionist trade pressures could overwhelm the political process in this country next year unless there is very clear evidence of very rapid movement toward resolving at least this aspect of the problem.

So in conclusion, I would suggest four or five measures that need to be taken explicitly and quickly in order to make sure the yen rises far enough and fast enough to resolve this part of the problem.

First, the obvious point, substantial further reductions in U.S. interest rates. That remains, I think, the single most important element of the picture, given the fact that U.S. inflation has now declined to the 5 percent range. We clearly need a further reduction in short-term U.S. interest rates of 2 to 3 percentage points. I think we need that for domestic reasons alone but that, too, would help dramatically in strengthening the yen in the exchange markets because Japanese interest rates would not tend to follow ours down.

Second, Japan's own Government and some of its Government agencies should be borrowing very extensively abroad and converting the proceeds into yen immediately to strengthen the yen exchange rate. That, not so incidentally, would help finance the Japanese Government's big budget deficit so it would kill two birds with one stone.

Third, there should be limitations on capital outflow by Japanese institutional investors. In my statement I suggested that a major reason for the yen weakness is a structural change in the Japanese capital accounts.

Mr. Peterson will probably talk about this more from his deep experience with that issue. But in two sentences, what has happened is that Japan for 30 years, until 2 years ago, had enormous growth in its economy, enormous increase in the wealth of its citizens, and very high savings rates, but almost no ability to invest abroad because of tight capital controls. So you had an enormous pent-up demand developing in Japan for foreign investment.

When the capital controls were liberalized 2 years ago, you got a classic portfolio adjustment. Japanese investors, especially institutional investors like insurance companies, took big components of their total portfolios and invested them abroad because, for the first time, they had access to trillions of dollars worth of foreign assets. The whole world of securities was out there which they had not been able to tap for 30 years. They began to do so.

That was intensified of course by the interest rate differentials, but purely on structural investment portfolio grounds there was created an enormous net capital outflow from Japan. That is good long-term policy, but in the short run it places huge downward pressure on the yen.

The Japanese through their famous administrative guidance can simply suggest to their big investors, "Cool it for a while, limit the outflow, strengthen the yen." They did it in 1979 when they ran big current account deficits. They can do it again, and they should.

Fourth, once the trend in the exchange rates is changed, as it may have already, toward a stronger yen, then I think it is time for stronger intervention in the exchange markets by the U.S. and Japanese authorities based on a common view that substantial further changes are needed in exchange rate relationships and that the authorities are determined to see that those changes occur. That was done to strengthen the dollar in 1978. It should be done to strengthen the yen now.

Finally, once a movement of that type is clearly underway and has governmental backing, I think we can rely on the private markets to take it from there. The bandwagon effects that we have seen throughout the history of flexible exchange rates tend to run with the tide. Once it is clear that a certain exchange rate trend is underway, the markets tend to run with that bandwagon.

I think if the other steps I mentioned could be taken and the Government indications of a need for change clearly put before the public, then it seems to me the private markets would probably take it further without more expenditure of Government funds. If need be, intervention could continue and push the rate up further and faster. I think at that point the private markets would take over and begin to move the rates in the way we would suggest.

In conclusion, Mr. Chairman, I would simply reiterate: It is a critical problem, the single most important problem facing U.S. trade policy today, and a major problem for our whole domestic economy because of the adverse effect on jobs and production and on economic growth of the deterioration that is in sight. It needs to be changed. Measures are clearly available to change it, and I am very, very pleased that the subcommittee is holding hearings like this to highlight the problem and speed its resolution.

Chairman GIBBONS. Thank you, Mr. Bergsten. You certainly stimulated quite a lot of questions in my mind.

[The prepared statement follows:]

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

THE DOLLAR, THE YEN AND U.S. TRADE

The Dollar Problem

The substantial overvaluation of the dollar in the exchange markets, in terms of the underlying competitive relationship between the United States and the other major trading countries, is by far the most critical trade problem now faced by the United States.

From its lows of late 1978 to its very recent highs, the dollar had risen in value by about 30 percent against a trade-weighted average of the other major currencies. During that same period, US inflation has on average run about the same as inflation in these other countries. Hence there has been an enormous deterioration in the international price competitiveness of the United States in world trade. Even allowing for some dollar undervaluation in late 1978 and the imprecision of all analyses in this area, the dollar is clearly overvalued by at least 20-25 percent.

The devastating impact of this situation on the US economy is already clear:

-- From the first quarter of 1981 through the third quarter of 1982, US net exports of goods and services in real terms declined steadily by a total of $22.5 billion (seasonally adjusted annual rate in 1972 dollars, as incorporated in the GNP accounts). This accounted for over three quarters of the decline in total US GNP during that period. The deterioration of the trade balance was far greater than the decline in the housing or automobile industries, and has been the single most important cause of the current recession.

-- The mechandise trade deficit reached an all-time record high in the third quarter of $52 billion (seasonally adjusted annual rate in current dollars, imports and exports both valued f.a.s. as in the balance of payments statistics). August was the worst trade month in the history of the country.

-- This dramatic deterioration in the trade balance has occurred despite the recession and a substantial decline in both the volume and price of oil imports. During all previous postwar recessions, the US trade balance has improved -- sometimes strongly, as in 1975 ($15 billion) -- because demand for imports has fallen along with demand for anything else. Moreover, the value of oil imports will probably show a drop of about $10 billion from 1981 to 1982. Hence one would have expected a notable improvement in the US trade balance this year instead of the enormous deterioration which has occurred, due almost wholly to the overvaluation of the dollar.

Unfortunately, we have only begun to see the adverse effects on the economy of the overvaluation of the dollar. A variety of studies show that the US trade balance tends to deteriorate by about $3 billion for every percentage point loss of US price competitiveness, with a lag of one to two years. We should thus expect an ultimate rise of about $60 billion in the trade deficit, even if the overvaluation is estimated conservatively at 20 percent.

Since the trade deficit was already running at about $30 billion in 1980, before the overvaluation began to occur, we should not be surprised to see it approach $100 billion. This level will probably be reached sometime in 1983 or early 1984, at least for a few quarters. For the full year 1983, the trade deficit will almost certainly range between $75 billion and $100 billion -- depending on the pace of the domestic economic recovery, the rate of growth (or lack thereof) in our major foreign markets and further changes in the terms of trade.

In any event, it is clear that the US trade deficit will soar to record levels in 1983. (The previous annual high was $34 billion in 1978; as noted, the previous quarterly high annual rate of $45 billion in the first quarter of 1978 was already exceeded in the third quarter of this year). The current account deficit will rise to at least $40 billion, almost three times the previous record (1977-78).

The deterioration in the US external position will take about one and one-half percentage points off our GNP, negating a substantial part of any recovery which might otherwise occur. Between one and two million job opportunities will be lost, intensifying still further the unemployment problem. In short, the overvaluation of the dollar with its impact on US trade is one of the foremost economic problems facing the United States in 1983 and beyond.[1]

These developments are particularly tragic because the international competitiveness of the US economy had been dramatically reasserted in the late 1970s. From 1978 through 1980, US exports rose twice as fast as world trade. Our share of world exports of manufactured goods rose to the level of the late 1960s, reversing all of the competitive losses of the earlier part of the decade. Our current account improved by $20 billion despite a rise of $35 billion in the cost of oil imports -- a gain of $55 billion on everything else. It became clear once more that the United States, taken as a whole, could compete quite effectively in the world economy. But the overvaluation of the dollar has undermined our position once more, and must be rectified immediately.

Moreover, throughout the postwar period, dollar overvaluation has been the single most important "leading indicator" of an outbreak of protectionist trade pressures in the United States:

-- In the late 1960s and early 1970s, import controls were imposed for the first time on steel and extended substantially on

[1] The rise in the value of the dollar has also helped reduce the observed rate of US inflation, of course, perhaps by 3-4 percentage points, from where it would otherwise be. However, the inevitable decline in the dollar (see below) will not only eliminate that source of improvement in the inflation numbers but propel them upward by a like amount. When determining an "underlying" or "core" inflation rate as a guide to policy, it is thus essential to adjust the published numbers for any temporary effect of exchange rate misalignments.

textiles and apparel; the House actually passed the highly restrictive "Mills bill"; and Congress seriously contemplated the Burke-Hartke proposals, which would have blocked most US imports of goods and most exports of capital and technology. Yet unemployment was relatively low during much of this period.

-- In the mid-1970s, barriers were raised on shoes and color television sets; restored for steel; and intensified once again for textiles and apparel. All this occurred while the United States was in fact recovering from the recession of 1975.

-- During the past two years, barriers have been imposed or extended in four major industries (autos, steel, sugar, textiles/apparel) despite the clear adherence of the administration to market approaches, including free trade. This time, of course, the impact of dollar overvaluation is intensified by the record postwar level of unemployment.

In a situation of severe dollar overvaluation, those seeking import relief (or export subsidies) have a very powerful case. Even Adam Smith and David Ricardo, along with all contemporary analysts, base the case for a liberal trading policy on several key assumptions -- including balance-of-payments equilibrium, which today takes the form of currency equilibrium. The AFL-CIO and other industries which seek government help in such an environment are really asking only for policy intervention to correct the distortions generated by other policy intervention (e.g., loose fiscal policy and very high interest rates) and non-intervention (e.g., in the exchange markets). I happen to believe that their desire to remedy the situation by erecting new trade barriers is misplaced and would be a tragic mistake, but it is clear that they are experiencing a real problem of substantial dimension and deserve a good deal of sympathy.

The Yen Dimension

The overvaluation of the dollar is most critical vis-a-vis the Japanese yen for both quantitative and qualitative reasons.

Quantitatively, the dollar-yen misalignment is more severe than the misalignment between the dollar and any other major currency. From late 1978 until early November 1982, the dollar had risen by over 50 percent in value against the yen. During that period, US inflation exceeded Japanese inflation (on most indices) by over 20 percentage points. Thus US international price competitiveness had deteriorated against Japan by over 70 percent in four years. Is it any wonder that the US-Japan trade imbalance has already soared to record levels and that a major crisis exists in economic relations between the two countries?

The qualitative impact of the dollar-yen imbalance is much greater than the impact of the dollar-DM or other imbalances because of the intensity of US trade competition with Japan -- both within the United States and Japanese markets, and in third markets around the world. This competition is far greater than between the United States and Germany, or any other country whose currency is also severely undervalued. A primary manifestation of this US-Japan trade intensity is of course the spate of protectionist trade proposals aimed at Japan which have come (or will come) before this Subcommittee, notably the "local content" legislation for the automobile industry[2] and the "reciprocity" bill earlier this year.[3]

This is in fact the third time in the past twelve years that currency misalignments have brought extreme tension to US-Japan economic relations. To be sure, there have been ongoing problems in that relationship which relate to structural factors going well beyond the exchange rate. But:

-- In the late 1960s and early 1970s, the initial outbreak of such tension was primarily caused by the exchange-rate disequilibrium that eventually produced the breakdown of the Bretton Woods system of fixed exchange rates, including the dollar devaluations and yen revaluations of 1971 and 1973.

-- In the mid-1970s, a second round of conflict developed largely due to a modest overvaluation of the dollar (triggered by the huge recession-induced US current account surplus of 1975) and Japan's unconscionable intervention to keep the yen from appreciating despite very large Japanese current account surpluses.

[2] It is instructive to note how US policy of the past two years has greatly strengthened the Japanese autombile industry. The "voluntary" quota foisted on Japan by the United States has voided any incentive for the Japanese auto firms to cut their prices to obtain a higher share of the US market; to the contrary, they have taken advantage of the fixed ceilings on the volume of their sales to raise prices substantially and sell higher quality (and thus higher priced) cars. At the same time, the exchange-rate misalignment has enabled the Japanese firms to make enormous yen profits when converting their dollar earnings. As a result of the interaction of these two phenomena, the profit of these firms have skyrocketed and positioned them to be even more formidable competitors in the future.

[3] For an analysis see William R. Cline, "Reciprocity:" A New Approach to World Trade Policy? (Washington: Institute for International Economics, September 1982).

-- Both of these past episodes were largely resolved when the exchange rates were corrected.[4]

Hence it is particularly critical once again to correct the yen-dollar misalignment, and to do so immediately. Expert judgements differ as to whether this requires the yen to rise in value to the level of 180 to the dollar, a point which it reached briefly in 1978, or merely to 210-220:1. All observers, however, including most Japanese, agree that a substantial adjustment is needed -- and needed very quickly. It should be noted that the yen has already risen by about 10 percent over the past month, from 280:1 to 250:1, so that the process may already be underway.

Before turning to proposed solutions, it is necessary to assess the frequent charge that "Japan is manipulating the yen" to hold its value well below market levels -- presumably to enhance the competitiveness of Japanese trade. As noted, Japan in fact did carry out such manipulation in 1976 -- and I happened to be the first person to discover their actions, or at least to indicate publicly what they were doing.[5]

During the present period, however, there is no evidence that Japan has been manipulating a weaker yen. Indeed, the Bank of Japan has intervened massively in the foreign exchange markets to keep the yen from weakening further; its published reserves have declined by over $5 billion this year as a result of that effort. Moreover, recent surveys of Japanese industry reveal that they themselves dislike the weak yen because it has sharply increased the cost of their oil and other imports -- and that the stagnation of the world economy has negated their enhanced competitiveness so that their export volume has fallen sharply anyway.

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[4] Details can be found in C. Fred Bergsten, "What To Do About the US-Japan Economic Conflict," Foreign Affairs, Summer 1982.

[5] See my testimony before the House Banking Committee on June 3, 1976 and before the Joint Economic Committee on October 18, 1976 as well as "Let's Avoid a Trade War," Foreign Policy, Summer 1976. All three are reprinted in Managing International Economic Interdependence: Selected Papers of C. Fred Bergsten, 1975-1976, Lexington, Mass: D.C. Heath and Co., 1977.

Indirectly, however, two Japanese policies have contributed significantly to creating such a high degree of yen undervaluation. First, Japanese interest rates are very low by international standards. Coupled with the very high interest rates which have prevailed in the United States over the past two years, partly due to the loose fiscal policy of the current administration and the resultant reliance on monetary policy to fight inflation,[6] the result has been a sizable incentive to shift funds from yen into dollars.

At the same time, however, it must be recognized that real interest rates have been quite high by historical standards in Japan as well as in the United States. (The explanation for the co-existence of Japanese interest rates that are low internationally but high by Japanese standards is of course the relatively low level of inflation in Japan which, until quite recently, has been far below the comparable figure in the United

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6. An early warning that this would happen can be found in my testimony of February 24, 1981, before the Subcommittee on International Economic Policy and Trade of the House Committee on Foreign Affairs.

States.) Moreover, the yen failed to strengthen for several months after US interest rates began their sharp decline this summer. Some of that failure can be explained by the continued high level of real interest rates in the United States and, as noted, the yen has now begun to strengthen substantially. But factors beyond changes in interest-rate differentials are clearly at work.

Many market observers believe that a major element in the picture is the general uncertainty now surrounding world economic and political events, which traditionally reinforce the "safe haven" role of the dollar. Others point to an apparent malaise within Japan itself, as its own dynamic economic growth has waned and its political system undergone a painful transition. Still others refer to the steady growth around the world of barriers to Japanese exports, which threaten Japan's future trade balances and thus the ultimate underpinning of its currency.

All of these factors have undoubtedly contributed to the undervaluation of the yen. However, I believe that the very powerful effects of a second Japanese policy -- the liberalization of its capital markets from late 1980 -- may be even more important.

For three decades after 1950, income levels in Japan rose enormously. A very high percentage of those incomes were saved. These high-saving, high-income Japanese had very little access to foreign investment, however, because of their government's very tight controls on capital outflow. Hence there must have developed in Japan an enormous pent-up demand for foreign investment.

When capital outflows were largely liberalized in December 1980, a classic portfolio adjustment began to take place. Japanese individuals and institutional investors, such as insurance companies, had access for the first time to trillions of dollars worth of dollar, DM, sterling, and other foreign securities. No one can judge how large this adjustment will ultimately prove to be, nor how long it will take to complete. But the wholly predictable outcome was an enormous export of capital from Japan.

On the other side of the balance sheet, liberalization also produced sizable capital inflows -- but of a much smaller magnitude. The previous incubation of the Japanese capital market meant that the increase of yen assets which had become available to foreign investors was relatively limited. Hence the "bottom line" was a substantial net outflow of capital from Japan, averaging $20-25 billion annually over the past year or so, and steady and sizable downward pressure on the yen.

Thus, the structural change in Japan's policy toward its capital account must have been a major factor in the subsequent weakness of the yen. This change was urged on Japan by the United States and other countries, and is surely the correct long-term policy. Japan is the second largest market economy in the world; its currency and capital markets can and should be major participants in international financial activities just as it participates so actively in trade and other economic endeavors. It can even be argued that, over time, internationalization of the Japanese capital market would make it far more difficult for Japan to maintain interest rates well below international levels -- and hence preserve an undervalued yen.

In the short run, however, the pace of net capital outflow from Japan has simply overwhelmed its current account surpluses and pushed the yen to levels which are far too low to sustain in terms of trade relationships between Japan and other countries (including, but by no means limited to, the United States). Hence any immediate effort to restore proper strength to the yen will almost certainly have to interrupt, at least temporarily, the liberalization of the Japanese capital market. In one sense, this would represent no more than a return to the immediate pre-liberalization period; in 1979 and early 1980, Japan actively manipulated its capital account -- virtually cutting off capital outflows and borrowing heavily abroad -- to finance the huge current account deficits which it ran for a period after the second oil shock.

A Prognosis and Proposed Policy Package

Given the encouraging appreciation of the yen over the past month, it is conceivable that the needed correction in exchange rates is already underway. There would be ample justification for such a development:

-- short-term US interest rates have come down sharply, narrowing substantially the gap in (both nominal and real) interest rates between dollar assets and yen assets;

-- the severe deterioration in the US trade and current accounts is becoming evident to the market, with four consecutive monthly trade deficits of sizable magnitude and a growing number of forecasts (including by official spokesmen for the administration) of huge deficits in 1983;

-- the completion of the electoral process in Japan may eliminate some of the uncertainty over the future course of its economy;

-- the increasing concern expressed in the US about the yen-dollar exchange rate, and the growing linkage between its correction and the prospect for avoiding protectionist trade actions in this country, may have already persuaded the Japanese authorities to move energetically to strengthen the yen (possibly by limiting capital outflows and borrowing abroad).

Moreover, the (relatively brief) history of flexible exchange rates teaches us that currency "bandwagons" move very fast once they start rolling. Virtually all observers agree that the dollar is substantially overvalued and the yen substantially undervalued, in terms of the underlying "fundamentals." If the market believes that the trend of dollar strength of the past two years has finally changed, it could therefore very quickly push the yen up quite far.

However, there have been several false starts during the past year -- when the yen (and other currencies) started to come up, only to fall back to (and beyond) their previous lows.

Moreover, it is unclear whether market forces alone will push the yen far enough fast enough; the current movement could peter out at 240:1 or so, leaving the yen considerably undervalued and remedying only a fraction of the competitive imbalance. And we are in a race against time: protectionist trade pressures seem likely to overwhelm our political process in 1983 or 1984 absent clear, substantial and continuing correction of the currency misalignment which promises within a finite period to restore some modicum of equilibrium in economic relationships between the two countries.

It would thus seem prudent to adopt some or all of the following measures as soon as possible, inter alia to restore proper exchange rate relationships among the dollar, yen and other key currencies:

-- further substantial reductions in US interest rates. With the decline in US inflation to the five percent range, short-term rates need to decline by another 200-300 basis points. In addition to its essential role in stimulating at least modest recovery of the domestic economy, this step would do far more than any other to promote the needed correction in the dollar exchange rate. Such a response would be especially likely for the yen, since Japanese interest rates are already low; some of the European countries might respond to lower US interest rates by easing their own monetary policies further, thereby muting to some extent the response in the exchange markets.

-- aggressive foreign borrowing by the government of Japan and its Parastatal Entities (Export-Import Bank of Japan, Long-Term Credit Bank, etc.), with the proceeds converted immediately into yen to strengthen the currency (and to help finance Japan's big government budget deficit).

-- temporary limitations on capital outflows by Japanese institutional investors, such as the insurance companies and banks, carried out informally via "administrative guidance" (as in 1979, when such outflows fell to zero for some quarters).

-- once the trend has clearly turned, joint intervention in the exchange market by the US and Japanese (and perhaps European) monetary authorities to accelerate the pace and extent of the currency movement. The authorities could let it be known that their intervention was based on a common view that substantial changes were needed in existing crossrates and that they were determined to see that such changes occurred; such steps would be the mirror image of the concerted international actions taken to strengthen the dollar in late 1978, and would represent an important milestone toward constructing a "target zone" system of cooperative international management of monetary relationships.

-- encouragement of private "bandwagon" movements which would complete the needed realignment.

It is also essential to note what policy should not do. The erection of new trade barriers in response to this monetary problem would be a tragic error, which I believe has already occurred in the steel industry.

It would be tragic because, given the present level of economic difficulties around the world and the degree of economic tension among the major countries, such action by the United States (especially) could trigger extensive trade conflict and go far toward destroying the GATT system which has been so central to postwar prosperity and world peace. It would also be tragic because new controls, far from solving the problem, would probably intensify it. Their promise to improve the US trade balance would tend to strengthen the dollar further in the exchange market, offsetting any "gains" from the controls themselves and in fact penalizing all American industries and workers for the protection of those who were most vulnerable (or politically powerful enough to be initially favored with protection). Despite the magnitude of the problem, new trade restrictions have no place in its resolution.

Conclusion

Needless to say, this package would require some important policy changes -- particularly on the part of the US administration. However, both in Japan and here, there are encouraging signs of recognition of the depth of the problem and the urgency of resolving it satisfactorily. The recent strengthening of the yen may in fact, at least in part, reflect that understanding.

In the United States the administration must simply face the inconsistency between its (correct) devotion to free trade, at least in principle, and its (incorrect) devotion to laissez-faire in the currency sphere. The latter has brought us to the brink of an outbreak of protectionism not seen in this country since 1930. Overt action on exchange rates, and indeed on the functioning of the international monetary system, will almost certainly be essential to preserve any hope for maintaining an open trade policy for the United States and hence for the world as a whole.

The cardinal issue remains the need to understand that the overvaluation of the dollar, particularly vis-a-vis the yen, is the central trade issue now facing the United States. Its impact on trade and on the US economy is enormous, and its impact on trade policy could be devastating. The Subcommittee is to be heartily congratulated for holding these hearings to highlight the problem and to speed its resolution.

Chairman GIBBONS. Before we start the questions, let's hear from Mr. Peterson.

Welcome to the committee. We are glad you had less trouble than Mr. Morgan did with his plane. For those on the committee who are not familiar with your background, I know you are the chairman of a distinguished investment firm, but you have also had broad experience here in the U.S. Government. I recall you served in one of the previous White Houses. At that time, you did all that you could to try to alert us to the problems of international economic policy. I regret that, unfortunately, we can't pay people like you enough money to keep you here in public service because we certainly need that kind of expertise. We will borrow some of it now. We would like to hear from you.

STATEMENT OF PETER G. PETERSON, CHAIRMAN OF THE BOARD, LEHMAN BROTHERS KUHN LOEB INC.

Mr. PETERSON. Thank you, Mr. Chairman.

First of all, I would like to say a few things about Lee Morgan and his great company in his absence as a way of making a much broader point.

I think what makes Caterpillar's testimony especially significant is that it does not come from a company, unlike many others in the United States, that has not spent major capital to improve its productivity. I know of few companies relatively speaking who have spent more than Caterpillar to improve its productivity.

Their testimony, secondly, does not come from a company, unlike many other companies, that have not had a global view of their markets. Few companies that I know in America have had a more global view than Caterpillar.

Third, the testimony does not come from a company that cannot compete in global markets. I know few companies that until recently have been more competitive in getting a global market share than Caterpillar.

This company, Mr. Chairman, has been doing too many things, too right, for too long to suddenly find itself losing global market share in major markets because largely of its own wrongdoings. I think you are seeing one of America's great enterprises which is simply illustrative of what is happening to many hundreds of others unless we take action, that is being weakened. And I was pleased while coming down to read Atlantic Monthly to see this isn't just the opinion of myself and many other business people. In a new book called "In Search of Excellence: Lessons from America's Best-Run Companies," I found it interesting Caterpillar was one of 15 companies so selected in America.

The point I am trying to make, Mr. Chairman, is that I believe the overvalued dollar in general, and the undervalued yen in particular, is a major contributor to the very serious problems that this company is having, that has cost it hundreds of millions of dollars of sales, millions of dollars of profits and, alas, thousands of jobs.

So I would like to join Mr. Bergsten and Mr. Morgan in asserting that the overvaluation of the dollar, especially vis-a-vis the yen, is in my opinion the single most important trade, indeed international monetary problem facing the United States today.

As my testimony attempts to demonstrate—and I am obviously summarizing it here—a major part of our very serious recession, and indeed a major reason in my opinion of the drag on the recovery, I would attribute to our dolorous, melancholy trade performance, which reflects the seriously overvalued dollar which in turn is costing our economy not just hundreds of thousands of jobs but, as Mr. Bergsten indicates, as many as a few million jobs.

I find it ironic, Mr. Chairman, and it is a testimony to what we in the Nixon administration, you recall, coined the MEGO subject—my eyes glaze over—international economics has always been a MEGO subject as you and I have discussed for a long time. I find it interesting that America's television, America's newspaper headlines are now focused on a gasoline tax and a public works program that, even by the testimony of its advocates, will create over an extended period of time a few hundred thousand jobs and at some cost obviously, whereas something of this sort, that is the overvaluation of the dollar, which my numbers were certainly very similar to Mr. Bergsten's, that has perhaps cost us a few million jobs is not a story that commands the attention of the American political body.

Now with Mr. Bergsten's technical expertise here, I shall avoid the personal embarrassment of attempting to display more technical knowledge than I have of this subject. Rather, I would like to deal with it in a more layman's, commonsense view, which is what I am anyway, a layman in this business.

First of all, what do we mean by an overvalued dollar?

Mr. Chairman, I have people saying to me, Mr. Peterson, don't you believe in the markets, which I obviously do. Don't you believe that something is worth whatever people are willing to pay for it?

So when you say overvalued—I say fair enough to that, the dollar is overvalued, what do you mean by that?

It seems to me, Mr. Chairman, that those of us who use the word "overvalued" are required to answer the question: "Overvalued compared to what?"

It seems to me there are at least two major components that many of us think about when we think of a properly valued currency. We think of a currency properly valued in what you might call the trade competitive sense of that word by which we mean, I think, the relative levels and trends of unit costs of the tradeable products across the world, one country to the next, that they trade in. That is one component of what I think we mean by a fairly valued currency.

The second is affected in a dominant way by what you might call not the flow of products but the flow of financial instruments, of capital, so there is the sense that a currency is competitive in that financial—fairly valued in that financial sense. In other words, money flows into financial instruments and investments in relation to the rate of return and the risk that investors all over the world can get.

Now what we have been seeing in my opinion, partly as a result of what Dr. Bergsten talks about in Japan, but also I think he would be sure to acknowledge for a set of other reasons, enormous flows into dollar-denominated instruments. Why?

It is very important to answer that question because it is this flow that to a substantial extent has strengthened the demand for dollars and therefore the price for dollars, and therefore this overvaluation that I talk about and he talks about in the trade competitive sense.

I wish that there was a simple theory. The latest is the safe-haven theory, which I happen to believe is one of the explanations but I do not think in many ways it is the most profound or sustained explanation. I think the single most important reason why so much money is flowing into the United States over an extended period of time in recent months is the unprecedentedly high interest rates, particularly long-term, real interest rates. If one goes on to say why has that, in turn, been happening, I believe it is attributable largely on the long term at least to the grotesque, unacceptable—use any set of words you want—long-term fiscal deficits of the United States.

My estimates indicate that in 1985, unless something is done—and let's pray that something is done—we are facing in this country a deficit of approximately 5½ percent of the gross national product, even in the context of 3 years of growth, and if we don't have that growth, it will be much higher than that, unless we do something.

I have included in my testimony—which I would like to have you include in the record—why I say that nothing is more important nor more basic than getting our own fiscal house in order. That is why a group of former Secretaries of Treasury and myself, as you perhaps know, have initiated and will early in next year launch a major public program of a bipartisan nature that will try to get at what we consider to be a balanced bipartisan program with major spending reductions in growth of the entitlement programs. And yes, I will say the words "social security," Federal pensions, veterans' pensions, et cetera, et cetera, and defense.

In my opinion, Mr. Chairman, if we don't get this deficit down to about 1½ percent of the gross national product heading south, not north as it is now, any chance we have of getting the kind of investment our economy needs to grow long term will simply not be there.

So this fiscal Frankenstein is not a Japanese problem in my opinion. It is our problem and our responsibility. As I indicate, I would like to practice what I preach and that is why our bipartisan group is spending a lot of its free time trying to create a situation where we help make politically possible what I think many of you privately would acknowledge: that what we now face is simply fiscally unacceptable and impossible over the long term. But there are also some things that others must do, including the Japanese.

First of all, let's move to this overvaluation on the trade competitive side. You were kind enough to mention my 1971 experience. I was stunned, Mr. Chairman, by the parallel by what I see now and what I found in early 1971. You will remember in early 1971, when you and I used to chat from time to time, the trade picture of the United States was descending at an alarming rate; protectionist solutions were being proposed all over the place, band-aids of all kinds were being applied on this product and that product, and there was a sense of despair and malaise in America that we had permanently lost our ability to compete, that we were going to become a service economy unless we put walls all around this country.

Now this was particularly true, allegedly, vis-a-vis Japan. You will recall the President asked me to do a comprehensive but quick study of the problem, and it was my conclusion, as well as that of my colleagues, that there was something more structural, more fundamental, albeit less glamorous going on, but ultimately more important.

That was that in the last half of the 1960's, as you will recall—the unit costs of American products vis-a-vis other countries, but particularly the Japanese—the unit costs were going up, as I recall, Fred, about 25 percent in the last half of the 1960's, and the Japanese unit labor costs for the entire decade were flat. But because we had a fixed exchange rate system, you will remember that that yen/dollar stayed in that fixed, if obsolete relationship.

Now, we concluded then, and I would conclude now, that unless we took vigorous action—and you remember at that point we took the famous, or infamous, depending upon your point of view, program of an import surcharge and closing the gold window. We got a major exchange rate alinement, as you recall, in 1971 followed by a still further one in 1973. As my testimony indicates, there was a major improvement in our position thereafter.

Now, the reason I have a sense of deja vu here is you and I will remember, as will the members of the committee, that the yen-to-dollar relationship in 1971 had been fixed for 22 years, as I recall, at about 360 to the dollar. Mr. Bergsten and I and others in the Government at that time took a look at these unit labor costs, this "trade competitive" definition of dollar valuation, and concluded that the yen was undervalued by at least 25 or 30 percent at that time.

That would have put an appropriate value of the yen then at that time at about 250 to 275. Ironically enough, that is about where it is today, but alas, what happened in the seventies and since 1971? I don't need to tell a group as sophisticated as you what has happened to the United States versus the Japanese labor costs during the seventies.

There has been at least an equivalent deterioration. Yet the yen/dollar relationship today is where it should have been roughly in 1971.

Now, in a recent trip to Japan that I took as a guest of the Foreign Minister, I met many of the leaders of Japanese companies and members of the various ministries, what was very different, Mr. Chairman, than 1971, was that virtually every one within Japan was unanimous in stating that the yen was very significantly undervalued. You and I will remember that that was certainly not true in 1971 when we were being told that this humble little country needed those reserves, and couldn't change its exchange rates and so forth.

I would say, Mr. Chairman, having talked to perhaps 30 different important people in Japan, including press, academics, business people, government people, the range of values on a trade competitive basis now are agreed within Japan to be somewhere between 180 and 210 to the dollar versus what we have had recently, 250 to 275.

So when I say overvalued, Mr. Chairman, what I mean by overvalued, is overvalued on this trade competitive basis. What we must understand is if the yen were indeed at 180 or 200, a Toyota that now sells for $5,000 would sell for $6½ or $700,000, and you can make the conversion as well as everyone else. We would have a radically different picture in terms of market share, in terms of jobs, in terms of sales and profit, if that were to come about.

Now, some experts seem to say, all right, Mr. Peterson, assume you are right that the dollar, as you put it, is overvalued. What is wrong with that?

I was presumably educated at the University of Chicago. I was told there that if any country was crazy enough to have an undervalued currency, that wasn't all bad, because what that meant was that the consumers in this country could get those real resources cheaper, artificially cheaper, thereby fighting inflation, thereby increasing the standard of living of the people. So there is a school of thought in some academic circles, as I am sure you will hear in the course of this testimony, that it is a blessing to have an overvalued currency.

Why do I think it is not a blessing? What, then, is the rub? It seems to me—and we are seeing it now in the greatly reduced level of sales, of profits, and jobs, of U.S. companies. There is a human aspect and there is a sharply defined political aspect to currencies, and to the trade aspects of currencies that greatly outweigh the diffused politics of exchange rates in terms of reducing inflation somewhat. One of my favorite words, Mr. Chairman, is the word "iatrogenic." It comes from the Latin and the Greek. It means diseases that are caused by the "iatra," the Greek for, "the doctor."

What concerns me so much and concerns Fred, I know, and others, is that in an environment of the type we have now, with grotesque unemployment to start with, with up to another few million jobs being lost, lost job opportunities, due to this dollar overvaluation problem, the so-called cure by the doctors is likely to be a protectionist cure that is far worse than the original disease. That is why I believe it is essential that anybody that is really interested in the consumer—and, Lord knows, this kind of protectionism would not be helpful to the consumer—must address some of these other problems that are likely to lead to these iatrogenic treatments.

Now, drawing, if I may, from my 1971 experience, what do we do about it? And I will try to stay as nontechnical as I can, which is easy. First, as in 1971, I would urge you and our Government to put primary emphasis on the basics, on the overriding issues, on the macro or structural issues, to use popular words, namely, this exchange rate situation, rather than using up all of our political capital and our intellectual capital on the specifics, on the micro, on the sectoral issues, on the citrus problem, on the textile problem, on the auto problem, et cetera, that you and I know so well. Of course, keep the pressure on those, but it is simply not enough.

The Institute of International Economics that Fred is the executive director of, which I am privileged to chair, has done some very interesting work, and I am delighted that you are including this in this testimony. But if you total up all of those microsectoral approaches, what you will discover is that even if you were successful in all of them, which is incredibly unlikely, it doesn't begin to approach the magnitude of the problem that we are facing, which is a $10 billion deterioration in recent months, which I think, Fred, could be at least another $10 billion unless something happens to this exchange rate situation.

So my first recommendation, Mr. Chairman, is to get our Government and to get our public policy to focus our fire on the big issue, to put our political horsepower behind the big issue, and simply make it perfectly clear, to use an expression from my administration, that that yen/dollar rate, and indeed the exchange rates generally with the dollar, are simply unacceptable to the U.S. Government.

Second, let's get our own fiscal house in order, and I say that for two reasons: First, it will make the major contribution, as I have indicated earlier, because part of our problem is this grotesque demand for dollars that arise from these grotesquely large deficits.

Nothing could be more salutary to interest rates long-term, interest rates short-term, exchange rates, the Third World debt problem, than a clear signal to the financial markets that we are finally getting serious about getting these deficits down.

The second reason I would focus on this, Mr. Chairman, and having negotiated with foreign governments, I think I know a little bit about what I am talking about, the kind of package that must be negotiated here is a tough one. As we discovered in 1971 vis-a-vis the French, it was our willingness finally to accept the fact that we too would be willing to devalue, as you will recall, Fred, thereby accepting part of the burden for the 1971 problem, that permitted us to get as large an exchange rate alinement in December through Secretary Connally as we got.

In that same vein, if the United States approaches these negotiations on the exchange rate from a base where we have taken major steps to put our fiscal house in order, I would urge the concept to you that we will be more likely to be successful than if we simply once again blame the foreigners for all our problems.

Third, I would make clear to the Japanese and others that we mean business, and that this is highest priority, and that in a quietly tough way we make it clear that we want results.

You will recall, because you and I discussed it in 1971, one of the virtues of the import surcharge, even though it was referred to by many as the Nixon shock No. 1, 2, or 3—I have forgotten which shock it was at the moment but it was certainly a shock—it clearly conveyed a message, and the message was: One, that we were serious, and two, that we were willing to negotiate but that we were willing to negotiate from a position of strength, namely, we would remove the surcharge when alinements were made and negotiations toward a more open world took place.

I would agree with what Dr. Bergsten said again. I think how the Japanese do it I would leave partly to them. In a sense, they can use some of the administrative guidance that they are famous for to achieve, to help us achieve a jointly arrived at result on the yen/dollar relationship.

Let me give you one example of this. Since I am now in the investment banking business, it is my business, obviously, to follow capital markets more closely than I used to. It does not take a great student of the Japanese capital system to understand that its capital markets are not nearly as open as ours.

There are a lot of restrictions on Japanese capital markets. It does not take a great student of foreign exchange to understand, as I told the Japanese when I was there, that I find it anomalous and interesting that "you are a senior partner in the world economy, by any standard I know anything about, and yet your currency is still a junior currency."

There are a lot of things that could be done to make the yen more of a senior currency in the world, which in turn would strengthen the demand for the yen which in turn would increase its value.

I am not here to tell them or you exactly how to do it. I am simply suggesting that there are ways they can make an important contribution to the problem.

Finally, as in 1971, I would urge you, and urge our Government, to look once again to structural reforms in the monetary system, and to keep an open mind about possible structural reforms. What do I mean by that?

Mr. Chairman, in 1971 it was again perfectly clear to anyone who looked at it that we had far too rigid an exchange rate system. The dollar hadn't changed vis-a-vis the yen in 22 years, but the world in 1971 was an extraordinarily different world than the world of 1949. Had that system not changed in a structural way in 1971, Fred, I don't know what would have happened to the world banking and financial system, particularly with the volume of petrodollars sloshing around, and so forth.

Try to imagine a monetary system in the seventies with fixed exchange rates convertible into gold, with literally hundreds of billions of dollars sloshing around. I haven't the imagination to imagine all of the consequences of that action. So, had there not been structural reforms at that time, we would have had very, very serious problems, in addition to not making the great progress that was made in the midseventies.

What is the right answer now, structurally? Again, I am not sure, but it seems to me that a direction to look at is whether there might be a new creative consensus of some sort from the excessive fixity, you might call it, of the fifties and sixties, to what might be the excessive fluctuation that we see today.

I don't know whether the right approach is to periodically set up target zones, for example, for exchange rates, which is one idea probably your group and others will be looking at. I do know, as someone now on Wall Street, that if speculators believe that there is a certain target zone that we are aiming toward, that speculation will, in and of itself, lead exchange rates in that direction.

While I was recently in Japan, Mr. Chairman, an ex-Minister, senior Minister of that Government, made a most intriguing suggestion to me, and again I am not enough of a technical expert to understand all its implications. He said to me, "Mr. Peterson, I believe the problem is serious enough that perhaps we in Japan should consider a large export surcharge."

Given Japanese translation problems in my own experience of 10 years earlier, I wondered if there had been a translation error of some sort. No, he meant an export surcharge, that is, a surcharge on all Japanese exports as a way of effectively revaluing the currency and spreading the effects across the entire economy rather than on particular industries.

I asked him why he would be interested in doing that. He said there are at least three reasons why many in Japan might support such an idea, as implausible as it seems to you at the moment. The first is, "remember" he said, "that we buy most of our products today dollar denominated. We buy enormous amounts of oil and other products dollar denominated. It is affecting our inflation rate, if you will, perversely."

Second, he said,"We are very much concerned about protectionist reaction that might take place and might hurt the whole world economy at a time when it is fragile enough including our own economy."

He said, "Third, we have a large fiscal deficit." I rather smiled when I heard him say that, when I think of their savings rate versus ours, but he said, "We have a large fiscal deficit, and a large export surcharge indeed might help in the financing of the deficit."

I am not suggesting that either of these ideas are the right ones. I am simply suggesting that I think as part of the inquiry here you should keep an open mind on how to reform the monetary system.

Sorry to go on so long, Mr. Chairman, but, again I commend you for your perceptiveness in holding a hearing on this MEGO subject which is immensely important in my view.

[The prepared statement follows:]

STATEMENT OF PETER G. PETERSON, CHAIRMAN OF THE BOARD, LEHMAN BROTHERS KUHN LOEB INC., AND CHAIRMAN, BOARD OF DIRECTORS, INSTITUTE OF INTERNATIONAL ECONOMICS

THE YEN PROBLEM REVISITED

As I see it Lee Morgan, Fred Bergsten and I have three rather different roles today. Lee Morgan, member of the Business Roundtable and his company one of the country's leading exporters, will give you some specific case studies that add a lot of credibility and impact to the assertion that the yen/dollar relationship has caused serious problems to some of this country's most important industries and most important companies within those industries.

Fred Bergsten has the technical background and the government experience to deal with immensely technical issues that are involved in the analysis and solution of the problem. Thus he can both define the problem in more precise, quantified terms and can lay out some possible solutions.

I, in turn, am neither an exporter or one representing a company or group of companies, nor am I a technical expert. Rather, I am a person who has an intense interest in the long-term revival of U.S. competitive economic strength and growth and the revival of the world economy, which is now going through economic and financial strains of unprecedented dimensions -- except for the Great Depression of the 30s -- but also with some new dimensions, like the serious strains that could arise from third-world debt now amounting to over a half trillion dollars. I have an equal interest in avoiding the series of "short-term," "protectionist" fixes that in my view will result in what the doctors call "iatrogenic" effects; that is, diseases or side effects caused by the treatment that in themselves can be as serious as the original malady.

Also I am a person who has had my own set of government experiences -- many of them involving international economics and trade in general and vis-a-vis the Japanese in particular. Perhaps this experience on how we dealt with the international economic malaise of 1971 gives me some perspective that may be relevant.

The over-valuation of the dollar in the exchange markets, especially vis-a-vis the Japanese yen, is in my view the single most important trade as well as international monetary problem which faces the United States today. As a result of these currency misalignments, the U.S. trade deficit is associated with something approaching three-fourths of the decline in our total economy since early 1981 and has been the largest single factor pushing us into recession -- larger than the slump in the housing or auto industries. This may seem like an extreme statement and I'd like to document it. In the first quarter of 1981, real GNP was $1,507.8 billion and by the third quarter of 1982, the real GNP had fallen by $29.4 billion (to $1,478.4 billion). About three-fourths of the reduction can be attributed to the fall of net exports of about $22.5 billion over that period.

The merchandise trade deficit (where many of our traditional jobs have been) has already risen to record levels and could even approach $100 billion in 1983. Thus, foreign trade has been a major drag on our economy and will clearly serve to weaken any recovery from the recession. It could easily account for between an additional one or two million lost job opportunities. Using the old rule-of-thumb of forty to fifty thousand job opportunities per billion dollars of manufactured goods, and putting that together with the Insititute of International Economic's estimate that the over-valued dollar could be costing us $60 billion in our merchandise trade account, one could even construct a bigger estimate of the number of lost job opportunities. I need not remind you that the current gasoline tax/public infrastructure program is talking of only 300,000 jobs or so, and over a period of time.

It is easy in these extraordinarily difficult economic times to blame the "furreigners" -- and the Japanese have, as now, been as convenient a target as anyone. Both in 1971 and now, I would yield to no one in the strength of my conviction that the Japanese have much they can and must do to reduce the unprecedented and unacceptable bilateral trade deficit.

However, I would want us to go far beyond the conventional approaches of some combination of blaming the "furreigners" and negotiating the always necessary reduction in trade barriers in this or that product -- be it textiles, citrus, beef, autos, or whatever. In the first place, all of the evidence of the Institute of International Economics suggests that even full Japanese compliance with U.S. requests -- which are too often based on an anecdotal approach rather than comprehensive and sophisticated analysis -- would have an effect substantially lower than the $10 billion change in the U.S./Japan bilateral trade balance over the last two years. The overall deficit now approaches $20 billion and will become much larger next year because of the continuing currency misalignment. We should focus on the areas which will achieve major progress in rectifying the overall problem, as they have before: restoration of a proper currency relationship between the dollar and yen, and sound management of our domestic economy.

I consider getting our fiscal house in order the absolutely necessary and fundamental step in getting long-term real interest rates down and getting our dollar valued more appropriately. Also, a credible U.S. fiscal program would help us immeasurably in negotiating the kind of tough-minded package that will be required with the Japanese and others for them to make their full contribution.

In this connection, I have attached a statement of a Bi-partisan Budget Appeal, organized by five Secretaries of the Treasury and myself, that will soon go public, supported by hundreds of leading Americans. This appeal stresses the need for a balanced program of major long-term spending reductions in both entitlement programs (Social Security ((see attached article)), federal pensions, veterans' pensions, etc.), defense, and to the extent necessary, consumption oriented taxes with energy consumption taxes (e.g., gasoline) playing a major role. Without a successful attack on the grotesquely large long-term structural U.S. fiscal deficits, I seriously wonder if there are any effective ways to get a more appropriate currency alignment on a sustained basis.

Before going on, I'd like to talk about the meaning of "overvalued" and "undervalued" currencies, since today's exchange rate system has some perverse effects, politically and perhaps even conceptually. Clearly, even using such a word as "overvalued" implies some kind of value system of a "fair" valuation that is different from what the current markets are saying the dollar is worth. This raises the obvious question: overvalued compared to what?

What many people are comparing the dollar's value to is what it would be were it based on its relative value vis-a-vis other currencies on a trade competitive basis -- that is, on the basis of relative unit manufacturing cost of a composite group of products that each country trades.

Indeed, if one compares these relative unit costs trends in various countries to changes in currency values, it is clear "something else" is playing a dominant role in setting the value of a dollar. That something else, of course, is the huge volume of capital flows, of financial flows into dollars, that increase the demand for the dollar and therefore increase its "value" which may, perversely enough, reduce the demand for American products.

In that sense, we may have a situation where dollar denominated financial products (with very high real and nominal interest rates) become much better "buys" than American manufactured products.

Deja vu

My initial personal experience with this range of problems came in 1971, when I was invited to become Assistant to the President for International Economic Affairs and Executive Director of the Council on International Economic Policy. The situation at that time was amazingly similar to what we face today: a dramatic deterioration in the U.S. trade balance, intense concern that Japan was coming to dominate world trade in a wide range of major industries, and strong calls for far-reaching measures (such as the Burke Hartke Bill) to protect the U.S. markets against Japanese and other imports.

Upon assuming office, the President asked me to launch a comprehensive -- and quick -- study of the problem (which was subsequently published). One of its major finds was that Japan had developed an enormous competitive advantage over the previous decade for many reasons -- but a principal one was that its unit labor costs had remained unchanged throughout most of the 1960s while unit labor costs in the United States were rising about 25%, with no offsetting change in the exchange rate relationship between the dollar and the yen. It thus became clear that currency realignments -- indeed a reform of the entire monetary system -- would have to be a major component of any serious effort to remedy the situation.

Such realignment did occur, of course, in late 1971 and early 1973. As a result, Japan's bilateral surplus with the United States returned to the much lower level of the late 1960's --even before the first oil shock distorted the international payments picture, Japan's global current account surplus was eliminated and the U.S. current account returned to modest surplus. In short, the exchange rate correction worked with almost textbook precision. Effective adjustments occurred and the first major episode of postwar U.S./ Japan economic conflict receded to much lower levels of intensity.

Before leaving this recitation of history, I would call attention to four of its particularly significant implications:

- First, the crisis was resolved only when the U.S. Government recognized the true nature of the problem and focused its attention on the big picture -- on the structural or macro problems. Through 1969/1970 and early 1971, official discussions with Japan had been centered on the problems of specific industries, such as textile and steel. As a result, the overall problem worsened dramatically and very little was achieved even on many of the specifics. The politics of trade policy were simply out of sync with the overall cause of the problem. But we were able to get major changes fairly quickly when we got our own act together and zeroed in on the overarching elements of the problem -- the exchange rate and the related behavior of our domestic economy.

- Second, systemic changes were part of the package. It became clear that the Brettonwood's system of fixed exchange rates was incapable of responding adequately to rapid changes in competitive positions, as had occurred between the United States and Japan during the latter part of the 1960's. The move to flexible exchange rates in early 1973 thus became an inevitable and essential element in resolving the contemporary problem, and even more importantly, of trying to prevent its recurrence in the future.

- Third, the United States had to get tough to achieve the needed changes. The package of measures announced on August 15, 1971, included the famous (or infamous) import surcharge and several other extremely aggressive steps, all viewed as tactical components of a strategy designed to elicit both immediate and systemic alterations of major consequence.

- Fourth, the United States had to make a major contribution to the package itself. Our agreement to devalue the dollar against gold, which had been so strongly resisted on a non-partisan basis for almost 40 years, was a sine qua non for working out the new array of currency relationships and, in 1973, the shift to a more flexible monetary system.

The Problem Today

The revival of many of these same problems today indicates all too clearly that the actions of a decade ago did not succeed in resolving them permanently. However, I believe that recent history is quite instructive in suggesting how we should now proceed. Before turning to the immediate issue before us, though, I would like to make one or two prefatory comments.

The first is to note how international economic events have become even more important to our economy than they were in the early 1970's. Since that time, the share of trade in our GNP has doubled -- in terms of tradable products, close to 25% are exported. The two oil shocks have made Americans conscious as never before of our international vulnerability -- the whole issue today is less a MEGO ("My Eyes Glaze Over") subject than in 1971. At the margin, external events can have a decisive impact on our economy: the sharp improvement in our trade balance from 1978 to 1980 provided three-quarters of the total growth in our GNP during that period and, as noted, the decline in our trade balance was the largest single factor pushing the economy into recession in 1981-82.

Second, important new efforts are under way to help understand and respond to the enormous challenges which international economic developments now pose for our country. One of those steps was the creation of the Institute for International Economics in late 1981 to provide the United States, for the first time, with a research institution devoted to studying the global economy and seeking ways to improve its functioning in the interests of both the United States and the world as a whole. I was willing to take on the chairmanship of the Institute-- and to work with other members of the Board of Directors such as George Shultz (before he became Secretary of State), Alan Greenspan, Michael Blumenthal, Anthony Solomon and Reginald Jones and prominent leaders from other countries, such as Raymond Barre, Karl Otto Pohl and Saburo Okita -- because the topic is so critical and because, with Fred Bergsten as its Director and a distinguished group of economists, I felt that the Institute could make a major contribution to dealing with problems such as those we are discussing today.

In fact, work done by Dr. Bergsten and his staff at the Institute has made a path-breaking contribution to our understanding of the yen/dollar issue and its impact on the trade and overall economic problems between the United States and Japan. It is a great advantage for me to be able to draw on their efforts today and I am pleased that Dr. Bergsten will be testifying to you himself later this morning. I know that this Sub-Committee has already drawn extensively on the work of the Institute, and I hope that you and your colleagues in the Congress will do so even more extensively in the future.

As to the substance of the problem, the United States is again going to have to focus its attention on the big picture in a sophisticated and comprehensive manner. If we continue to use our political capital to pursue the latest specific or anecdotal problem, the results will continue to be meager and the Japanese (as well as the rest of the world) will continue to laugh all the way to the bank.

The politics of trade policy, with their focus at the micro-economic or sectoral level, simply must be meshed with the aggregate issues which are so decisive to the outcome for each industry as well as to the overall economy. We simply must focus on the one or two overarching issues which, if handled properly, can restore our competitive position and make our trade sector once more a source of positive support to the level of economic activity and employment in [illegible] United States -- instead of the enormous drag that it is [illegible]

The most [illegible], as in 1971/73, is to restore equilibrium in [illegible] te relationship between the dollar and other [illegible] es, most notably the yen. As Dr. Bergsten will indicate in detail later, the dollar is over-valued by at least 20% on average and considerably more against the yen. From late 1978 to its recent high, the dollar has risen by a trade weighted average of about 30% -- and by more than 50% against the yen. Using March 1973 as a base, Morgan

Guaranty's world financial markets showed that the yen had depreciated to mid-October by almost 25% on a real effective basis and the dollar had appreciated by about 23% -- whereas the DM and most other currencies (except for the substantially over-valued pound and undervalued Belgian franc) were within 10 points of their starting level. A correction of the dollar-yen misalignment is the central problem now confronting U.S. trade policy.

Some observers, including in the Administration, have taken the view that it is impossible for policy changes to correct the overvaluation of the dollar (even if such an outcome were viewed as desirable). They point to the continuing strength of the dollar in the face of substantial declines in U.S. interest rates and the deterioration of the U.S. trade balance which has already occurred, and conclude that the "safe haven" appeal of the dollar in an uncertain world and the reduction in U.S. inflation may sustain it indefinitely.

One gets a slightly different view in Japan, as I did on a recent extensive visit there. I believe that many Japanese would like to see a stronger yen, because the weakness of their currency has sharply increased the cost of oil and other imports and, by raising fears abroad of enhanced Japanese competitiveness, fuel the fires of protectionist pressure against Japan. But most Japanese also believe that the problem is primarily one of dollar overvaluation rather than yen undervaluation, and that it is therefore up to the United States rather than Japan to take remedial action. All Japanese reject the charge, as do I, that their government has recently been actively manipulating the exchange rate of the yen to keep it weak.

I am far clearer about the problem and its importance than I am about the technical aspects of the solution. The ebbs and flows of international capital are very deep and treacherous waters and precisely how to navigate through them is well beyond my technical depth. I shall leave that to the experts like Mr. Bergsten, the Treasury, Federal Reserve and whoever feels they have the expertise and courage to tackle them.

However, just as war may be too important to be left to the generals, I am not at all sure that we should simply leave at least the setting of our priorities of our nation's international economic objectives to the technicians.

For one thing, the ebbs and flows of trade -- and in particular the jobs, sales, and profits that go with that trade -- are immensely political rather than simply economic. For example, economists would tell you that an overvalued currency, as we are now experiencing with the dollar relative to the yen, in not without its advantages and they would be right. Obviously, it permits our consumers to buy foreign products with fewer dollars, thereby increasing their standard of living, and lowering the rate of inflation. In this latter respect, the Institute for International Economics has estimated that the current level of inflation would be 3 to 4% higher with the dollar more "properly valued," that is, on a trade competitive basis.

Alas, the other side of that overvalued coin is that jobs and industrial activity could be far more. Clearly, the difference between a yen at 275 to the dollar and one at 190 to 200 to the dollar is the difference between a Toyota at $5,000 and one at $6,500. That would, of course, mean that fewer Toyotas and more Fords, Chryslers, GM and AMC cars would be sold, along with the jobs and profits that would go with these added sales. This latter phenomenon, of course, speaks particularly to the politics and human aspects of trade. First, the organizations concerned with jobs, sales and profits feel the negative effects of an overvalued currency on them far more directly (particularly when the Japanese focus so much of their drive for global exports on so few manufacturing sectors (steel, autos, electronics, etc.)) than do the much larger diffused group of consumers who are presumably enjoying, however unconsciously, the benefits of these artificially cheapened foreign imports. Second, these organizations are more organized and effective politically than that diffused group we call consumers.

Thus, the choice in the so-called real world of politics is not a benign one between a fully employed economy enjoying the diversity and low prices of undervalued foreign imports and a fully employed economy not enjoying such diversity and low prices. It is likely to be a more malign environment in which aggravated unemployment (already very high) leads to various kinds of "solutions" which are, as I indicated before, what the doctors call "iatrogenic," that is, treatment where an ailment or a side effect is caused by the treatment itself. Thus, the political response to this negative effect of an overvalued dollar on jobs, sales and profits is likely to be what we are now experiencing, and were experiencing in 1971 when I was in government; namely, a very intense drive for various protectionist measures that most emphatically are not in the interest of the consumer.

In fact, the yen has risen by about 10% against the dollar during the past month. This is a hopeful sign, but it is not yet clear that market sentiment has turned decisively in the correct direction. Drawing on the lessons of the past, it does seem clear to me that we should pursue a plan of action along the following lines:

First, we should clarify -- to ourselves and to the Japanese -- that correction of the currency misalignment is the cardinal policy objective for the foreseeable future -- indeed, until the yen strengthens to perhaps at least 200:1 against the dollar. The confusing array of secondary and tertiary policy goals must be subordinated to this overriding objective, which must be conveyed to the Japanese in the clearest and strongest possible terms (it is instructive to note that Japanese intervention to block any significant strengthening of the yen halted abruptly in early 1977 when the United states clearly indicated that such a policy was completely unacceptable to it and that the yen subsequently appreciated by over 30% in 15 months -- even before the excessive dollar slide of late 1978).

Second, because the over valuation of the dollar is a general phenomenon and because U.S. real interest rates remain excessively high by both historical and international standards, the United States must act decisively to contribute to the needed currency correction (as well as boost its domestic economy)by getting real rates down a good deal further. Real U.S. interest rates are still running at 7-8% at the long end of the maturity spectrum and 3-4% at the short end -- much higher than in most other countries, especially at longer term. As I have indicated, the needed reduction in interest rates in turn requires decisive action to reduce the prospect for huge budget deficits which now loom as far ahead as the eye can see. I am afraid that the U.S. contribution must at least consider a renewed willingness to intervene directly in the foreign exchange markets to help achieve the needed realignment -- just as Japan and other countries intervened cooperatively to help restore a stronger dollar in 1978-79.

Third, because the undervaluation of the yen *is* greater than that of other major currencies and because the yen problem has a far greater impact on U.S. trade (and trade policy) than the DM problem or those of other currencies, Japan has an obligation -- and a strong self interest -- in contributing to a speedy resolution of the issue.

For the longer run, greater balance in the Japanese capital account would be promoted by much more conscious effort to internationalize the yen. While Japan is certainly a senior partner in world trade, the yen is still a junior currency by any standard. Japan should eliminate all barriers to investment in yen assets, and make every effort to improve the attractiveness of the Tokyo capital markets. This process will take time, but it is essential to avoid periodic bouts of excessive downward pressure on the yen caused by an inadequate balance between Japanese capital outflows and inflows.

Fourth, to avoid yet another repetition of this problem a few years hence, further systemic reforms will probably be needed. In the early 1970's, it became clear that the old system of fixed exchange rates had become too rigid and that greater flexibility was needed. Now, it has likewise become clear that the system of flexible rates is too prone to over-shooting and bandwagon effects -- often unrelated to the underlying trade and economic relationships among nations, but rather to capital flows. We are going to need some kind of synthesis between excessive fixity and excessive fluctuation, perhaps by adopting a system of target zones whereby countries continue to eschew any effect to refix parities for any extended period but to work together continuously to keep rates from moving too far from equilibrium levels and to push them quickly back inside such zones if they do stray too far. Indeed, early agreement by the U.S. and Japanese authorities on a target zone for the yen/dollar rate could have major expectational effects which would promote the needed recovery of the yen.

Finally, the question arises as to whether the U.S. should (or will have to) "get tough" to bring all this off. One possibility would be, again, imposition of a temporary import surcharge to prod the needed currency changes. Another, suggested to me by a former Japanese cabinet official, would be for Japan to levy a temporary export surcharge instead. He argued that a significant export surcharge would not only help significantly to reduce their trade surplus but would help finance a large fiscal deficit. This latter idea is one I think our technical people should explore.

My strong preference would be to avoid unilateral, protectionist steps. For one thing, the creation of new trade barriers could perversely push exchange rates in the wrong direction -- by strengthening the U.S. trade outlook and/or weakening the Japanese outlook, the dollar could strengthen anew and the yen weaken anew. Moreover, resort to such measures at a time when the entire trading system is under such major assault could lead to a further spiral of trade restriction whatever the motives for the original move.

We should, therefore, make every effort short of such steps first. I am confident that a program along the lines suggested here can succeed in remedying the paramount trade problem which our country faces today.

May 24, 1982

A BI-PARTISAN APPEAL
TO
THE PRESIDENT AND THE CONGRESS OF THE UNITED STATES

The Hon.	The Hon.	The Hon.	The Hon.	The Hon.	The Hon.
W. Michael Blumenthal	John B. Connally	C. Douglas Dillon	Henry H. Fowler	Peter G. Peterson	William E. Simon
Sec. of Treasury	Sec. of Treasury	Sec. of Treasury	Sec. of Treasury	Sec. of Commerce	Sec. of Treasury
1977-1979	1971-1972	1961-1965	1965-1968	1972-1973	1974-1976

The budget crisis can wait no longer. The huge budget deficits now in prospect are crippling today's economy and could lead to years of financial turbulence and industrial stagnation.

This is no time for politics as usual and it is certainly no time for a budget stalemate. The national interest demands strong and continuing leadership—by the President and Congress working together—to restore financial sanity.

THE DEFICITS IN PROSPECT . . .

The federal budget is dangerously out of control. Without swift legislative action, it will produce a succession of ever-widening deficits. In Washington, there is finally a broad consensus and genuine concern about the magnitude of the problem.

- The current year deficit is running in the range of $100 billion.
- Unless laws and trends now in place are changed, the deficit could explode into the $175-$200 billion range in FY 1983.
- By FY 1985, the annual deficit could be in the $250 billion range, and heading upward.
- The deficits now in prospect could well exceed 5% of GNP, year after year. Federal borrowing would devour virtually every penny of household savings and would divert capital from productive investment at a record rate.

Peacetime deficits this big have no precedent in our history. Though recent years have seen too much red ink, really large deficits have typically occurred only as the result of recessions and have narrowed swiftly with the resumption of economic growth. But the spending and tax laws now in place would produce a continuous flood of gigantic deficits even if the economy now recovered and enjoyed sustained growth. As now structured, the federal budget might never achieve balance—it would more likely sink deeper into the red with each passing year.

THE PROBABLE RESULTS . . .

Huge deficits risk denying Americans any chance at sustained prosperity in the new decade—after a decade in which real median family income showed little or no increase.

- Recovery from today's recession could be feeble and temporary as a result.
- Interest rates would remain abnormally high, holding back new investment and pushing thousands of sound businesses and farms into bankruptcy.
- Job creation would continue to stagnate, making higher unemployment a fixed feature of the industrial landscape.
- Dollar exchange rates would remain artificially high, choking off American exports, sucking in imports, destroying hundreds of thousands of U.S. jobs, and pushing us toward full-scale protectionism.
- Low investment would erode our long-term productivity growth, retarding living standards at home, crippling our competitive ability in international markets, and shrinking America's stature and influence in the world.

PRINCIPLES FOR SOLUTION . . .

The budget crisis transcends conventional politics; no solution is possible through partisan maneuver. We, the undersigned, rarely stand together on political and economic issues. But we believe Americans must now rally to the common cause of fiscal responsibility.

There are five crucial principles for budget reform:

- **Realism:** The financial markets are telling us that it does no good to "cut" the deficits by using unrealistic economic and revenue forecasts, or by underestimating expenditures, or by relying on vague and speculative "savings" to be proposed in the future.
- **Speed:** Action is necessary right now: Delay would permit election year politics and momentum of federal spending to lock in huge deficits all the way to mid- decade. With each week of delay, the problem is getting worse—and harder to solve.
- **Long-term impact:** The financial markets—and the American people—are worried by today's deficit but much more by the huge deficits now in prospect for 1983, 1984, 1985 and beyond. Today's budget actions must cut those out-year deficits substantially; the reforms adopted must be equal to the size and duration of the problem. The reforms must be large, structural, and permanent.
- **Fairness:** Balancing the budget on the backs of just one group or one set of programs, is not feasible, and trying to do so is not fair. Federal spending has grown excessively in many categories for many years. The growth rate has recently been cut for certain means-tested programs aimed at the poor, such as Medicaid, AFDC, Food Stamps, and legal assistance. It is now time for a wider sharing of burdens—for focusing fiscal reform on the major spending programs which confer benefits on middle and upper income groups.

- **Focus on investment:** The chief vice of uncontrolled spending and big deficits is that they rob the future—by absorbing investment capital needed to build up productive jobs and real income for tomorrow. The 1980's should be a decade of investment, not a decade of red ink. Budget reform should protect the future: we must squeeze down the share of GNP taken up by Federal spending, concentrating the cuts on public consumption, not public investment, and the needed tax increases should fall chiefly on consumption, not on private savings and investment.

- **THE GOAL . . .**

We must put the budget on a multi-year path toward balance. This means cutting the FY 1983 deficit to below $100 billion and squeezing down the deficit further in each year thereafter. To achieve even minimal credibility in the financial markets, the program of fiscal reform must cut the projected deficits:

- **by about $75-100 billion in FY 1983**
- **by about $125-150 billion in FY 1984**
- **by about $175-200 billion in FY 1985**

If we do less than this, future deficits will likely remain well above 2% of GNP for years to come—which would make the nation's financial and investment situation in the 1980's even worse than it was in the 1970's. The last decade was bad enough for America's economic performance. To invite a further drop in our economic performance would be totally irresponsible.

A PROGRAM FOR IMMEDIATE ACTION . . .

We can meet these targets without gutting our military security, without starving private savings and investment, and without putting harsh burdens on the poor. But meeting the targets does require us to address head-on each of the three major sources of runaway deficits—the growth of the large entitlement programs, the growth of defense spending, and the inadequacy of tax revenues. If any of these areas is placed "out of bounds" no fair or effective solution to the problem is possible.

1. **Entitlements and other non-defense programs:** We should now slow down the growth in non-defense spending so as to reduce the deficit by about $60 billion in 1985. The best place to begin is with a one-year freeze in benefits flowing from the large, broad-based entitlement programs—Social Security, Medicare, veterans' benefits, Civil Service and military retirement, and other non-defense subsidies and payments. Thereafter, there should be limits on the automatic inflation-indexing of benefits (e.g., by capping inflation adjustments at 4% a year, or by providing adjustments only for inflation exceeding 3% a year). However difficult politically, controlling the budget requires controls on the large entitlement programs and on the inflation indexing process that drives the cost of those programs upward. If those programs are instead placed off limits, it will be impossible to make budget savings of the magnitude now necessary for financial stability. Similar restraint is required on all transfers, subsidies and programs other than those essential to the needy; these measures can be carried out in ways which protect those citizens truly in need.

2. **Defense:** The defense budget increases now planned should be moderated so as to save about $25 billion in FY 1985. This would still provide for a major and sustained defense buildup, and it would also encourage more explicit planning for that buildup and lead to wider public support for a strong defense posture.

3. **Taxes:** Revenues should be increased by about $60 billion in FY 1985. This can be done through a variety of permanent and temporary tax measures; e.g., new taxes on oil, gasoline, and natural gas consumption, such as a tax on imported oil, or a gasoline tax or decontrol of natural gas with a windfall profits provision (which would also prolong the current world oil glut and assure further energy conservation and production activity by the private sector); modifying corporate tax provisions (e.g., safe harbor leasing) which distort business investment flows; and by increasing federal excise taxes, such as on alcohol and tobacco; and by imposing user fees for the government's commercially valuable services. Modifying, delaying or stretching out of the income tax cuts scheduled for 1983 has the unanimous consent of the undersigned only in the context of a prior agreement on the kind and magnitude of spending cuts referred to in parts 1 and 2 of this program.

These steps, if undertaken now, would cut the FY 1985 deficit by about $145 billion. This in turn could lead, through less federal borrowing and lower interest rates, to a further deficit reduction of $30-55 billion, meeting the overall target of about $175-$200 billion in FY 1985 deficit reductions.

After the November elections, the President and Congress must turn to fundamental reforms of the fiscal structure; e.g., developing a multi-year budget control system to guarantee realistic, long-term discipline on spending and tax decisions; making structural changes in the Social Security system, to assure the system's long-term affordability and financial integrity; and giving serious consideration to a new and general consumption-based tax. But the difficulty of such basic reforms must not divert us from the need to take major steps right now to cut future deficits.

LEADERSHIP . . .

The program we suggest would require tangible sacrifices from many middle and upper income citizens—but the sacrifices would not be severe. And they are simply necessary to avoid economic chaos and stagnation. Inaction would exact enormous—and unnecessary—sacrifices from every American.

The budget crisis is a national crisis. Only a united leadership in Washington—extending across both parties, and embracing liberals and conservatives alike—can avert a fiscal disaster. Let us work together, as Americans, to rescue the future of our economy . . . and of our country.

[From the New York Review, Dec. 2 and Dec. 16, 1982]

SOCIAL SECURITY

(By Peter G. Peterson)

I. THE COMING CRASH

Social Security's troubles are fundamental. Its financial problems are not minor and temporary, as most politicians, at least in election years, feel compelled to insist. Unless the system is reorganized, these problems will become overwhelming. To put the matter bluntly, Social Security is heading for a crash. We cannot permit this to happen, because it would put the nation itself in very serious jeopardy. Though in effect for only two generations, Social Security has become the defining link between citizen and state in modern America. It has such uniform and reverential support that if the system crashes, so almost certainly will civic harmony and the economy itself. The prospects for Social Security and for general prosperity are now inseparable.

The Social Security system has become a high-risk gamble on economic progress and population growth—a bet by today's workers that their children and grandchildren will be rich and numerous enough to foot the bill for another round of generous retirement benefits. Should this hope go even mildly awry, today's workers will retire into a Social Security system running deficits larger than the total benefits it pays out today.

Meanwhile the system—which spent over $190 billion in fiscal 1982—has already grown so colossal as to shape the entire future of the economy. Social Security spending has moved from 1 percent of the entire federal budget in 1950 to 26 percent today. By far the biggest government social program in world history, the system now spends each year more than the combined net investment in plant, equipment, research, and development of all the private companies in the United States.

During the past few years, we have witnessed a revolt against both the burden of rising federal taxes and the binge of spending which has made those taxes necessary. In many ways, Social Security is the prime mover of both. A little-known, but important, fact is that between 1955 and 1980 Social Security taxes more than accounted for the increase in federal revenues as a percent of GNP. The growth in Social Security outlays is responsibile for almost all of the increase in federal outlays as a percent of GNP. Thus, were it not for the growth of Social Security, federal revenues as a percent of GNP would have declined and federal outlays would have remained virtually unchanged.[1]

There is of course more to the Social Security puzzle than economics. It raises questions of ethics as well. Is a "contract" between generations fair when it gives today's older people a vastly higher return on their contributed taxes than their children and grandchildren can possibly hope to receive? Is a welfare program that gives almost 30 perent of its tax-free benefits to the 20 percent of the elderly population with highest incomes what we want? (Incidentally, that 20 percent of the elderly population has a family income of $30,000 per year or more, and those over sixty-five who are married to nonworking spouses can expect to receive tax-free benefits that will total about fifty times their lifetime payroll tax contributions.)

Still, if Social Security's financial problems cause the entire economy to fall into perpetual stagnation, robbing our children and grandchildren during their working and retirement years of their rudimentary economic security and indeed of even their Social Security, such ethical dilemmas of the Social Security system will become irrelevent. One of the highest moral obligations facing us is to give our offspring a decent chance at prosperity. If we fail there, the Social Security system itself, and much else, will disappear.

1.

The US economy is suffering from a progressive disease—a spreading paralysis of those activities that raise the standard of living. I am not referring to the current recession. In discussing Social Security and our economy, we must learn to think of decades and generations. Americans, ever impatient, are inclined to mistake short-term cycles for long-term trends. But the economy's worst problem is not in fact today's high unemployment or yesterday's soaring inflation. Rather, it is described in the following comparison:

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[1] Between 1955 and 1980, federal outlays rose from 18.0 to 22.4 percent of GNP while Social Security outlays grew from 1.2 to 5.3 percent of GNP. Social Security payroll taxes rose from 1.3 to 5.4 percent of GNP, more than accounting for the increase in federal revenues from 17.2 to 20.1 percent of GNP.

Annual Productivity Growth Rate [2]

	Percent
1948-67	2.5
1967-73	1.6
1973-81	0.1

As these figures show, America's machinery for creating national wealth is slowing down. The ability of our workers to produce more each year is becoming weaker each year. This slump in the growth of productivity now has little visible effect on daily life. But the cumulative impact will be enormous. Consider the year 2020, when those who are now infants will be at their working prime. If productivity stays roughly the same—if the trend of recent years continues (but does not get worse)—the average workers in 2020 will produce $22,800 in goods and services, just about what he does today.[3] The country, for the first time in its history, will have stood still for a span of forty years. (By contrast, the last forty years have seen real income produced per worker rise from $10,000 to $22,000 or about 120 percent.)

If, on the other hand, productivity were now to start growing again at the 2.5 percent rate which prevailed from 1948 to 1967, the average worker in 2020 would produce $57,700 in goods and services, an increase of about 160 percent. In that case, our grandchildren would look back on us as relative paupers, and would by 2020 be enjoying a buoyant prosperity and widening social opportunities in a nation that was a strong force in the world's economic and political affairs. But we are instead on a course leading to uprecedented stagnation, almost certain social strife, and steadily diminishing international influence.

Why are we heading toward the wrong future? Many managerial and cultural factors are responsible, and their relative importance remains a matter of dispute. But one factor seems prominent in virtually every study that has been made: the productivity of U.S. workers is stagnating largely because they are not being provided with an adequate flow of both new tools—modern plant and equipment, innovative techniques, improved methods of production—and new products.

New tools and ideas are provided by investment—by adding to the stock of capital, physical and intellectual, that will generate income in the future. We have been underinvesting in the future. A comparison with Japan during the Seventies is instructive, and sobering:

Japan invested nearly three times as much in new corporate plant and equipment (9.8 percent of GDP vs. 3.4 percent in the U.S.).[4]

Japan invested over seven times as much in public "infrastructure" such as roads and waterways (5.0 percent vs. 0.7 percent).

Japan invested 20 percent more in civilian research and development, exclusive of R & D for space and defense (1.9 percent vs. 1.6 percent).

The differences between Japanese investment in scientific education for the young and that of the U.S. are huge, if not as precisely measurable.

Instead of investing adequately in such productive activities, we have, to a dangerous extent, been creating huge debts for other purposes, notably private consumption, and particularly Social Security and public pensions. The true levels of national debt are different from what most people assume; the public believes that the federal debt consists of the loudly announced sum of $1 trillion. In fact, the Social Security system has an "unfunded" liability (i.e., the amount by which expected benefits to current participants exceed their scheduled future taxes) of over $6 trillion. The unfunded liabilities of the federal and military pension system approach another trillion dollars. Nothing could be more salutary for the prospects of long-term productive investment and indeed the global financial system than the news that these grotesquely large obligations to pay public retirement benefits were being reduced and brought under control.

Investment requires savings. One reason we are investing too little is that we are using up every year, in current and often imaginative consumption, far too much of the income we are producing. The national pool of savings available for investment is shallow. This is because the flow of personal and business savings into the pool has been inadequate and the federal government's burgeoning deficits have become an enormous drain on the pool. Compared to those of all other industrial countries, savings from individuals and families in the U.S. have been a mere trickle. Between 1970 and 1979, for instance, the household sector of the economy saved on average only five cents of each dollar earned. The comparable figure for Japan was about fifteen cents of each dollar earned.

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[2] "Productivity" refers to real domestic income per employed person.

[3] All sums are computed in constant 1980 dollars.

[4] GDP (Gross Domestic Product) differs from GNP only by attributing all production to the country where it is located (i.e., ignoring international income flows). All investment is measured net of depreciation.

The chief explanation for this difference is very straightforward. The Japanese have consciously designed their entire system of economic incentives to reward savings and investment. We have largely rewarded borrowing and consumption. For example, no other major industrial country permits unlimited tax deductions for interest. In Japan, moreover, personal income derived from capital—i.e., from savings—is taxed either lightly or not at all. In the U.S., such "unearned income" suffered especially high taxes until recently, and still enjoys relatively small tax incentives.

In Japan, buying houses and durable consumer goods on credit is difficult and requires big down payments. In America, the tax laws and the banking system are heavily skewed toward financed consumption—i.e., toward keeping savings at the lowest possible level.

Pensions in Japan—both public and private—are meager, forcing workers to save for their retirement. Social Security in America now seeks to provide every eligible retired person, regardless of need, with a stipend sufficient to cover all or at least most of the basic necessities of life. The need to save is accordingly weakened. As for American corporations, while their flow of savings (so-called "retained earnings") has traditionally been considerable, a sustained binge of corporate borrowing has been dangerously eroding that tradition.[5]

We have thus become a nation of spendthrifts and Japan a nation of savers. But it is an illusion to think that we could quickly or simply change our laws, institutions, habits, and culture so that they will more closely resemble those of Japan. The recent changes in the tax structure to encourage more saving by households and businesses will prove helpful, but further changes in the tax system, though necessary, will require a long and hard effort, and the amount of additional savings they might provide remains uncertain.

2.

Of necessity, we must turn to a surer and more direct strategy for enlarging the pool of savings available for investment: namely to stop the government from draining the savings pool. The government finances its deficits by using up—literally extinguishing—the savings generated by the country's citizens and corporations. This government "dis-saving" has taken on new and frightening dimensions over the last several years, and the problem is getting worse.

The recent rhetoric about the evils of deficit spending and the debate over the balanced-budget amendment have partly hidden a distressing reality. The US now faces federal deficits so large, so long-term, and so unprecedented that if or when an economic recovery occurs our shallow pool of savings would be substantially depleted. There would be little left to sustain the indispensable levels of investment we need to restore economic growth and international competitiveness.

In view of widely publicized efforts of the Reagan administration to reduce spending, this may seem surprising. In April 1981, the president stated his aim of reducing both spending and taxes to a bit over 19 percent of the Gross National Product by 1985—admirable goals, but only if they are achieved together. Regrettably, the goals have been pursued separately. Tax revenues have indeed been reduced to 19.1 percent of the GNP by the biggest, and, I fear, gaudiest tax cut in history. But spending, meanwhile, is now projected to rise dramatically from 22.4 percent of the GNP in 1980 to an intolerable 24.6 percent of the GNP in 1985 unless something is done.[6] This would amount to a rise from $577 billion to $967 billion, the latter figure being $123 billion above the president's 1985 spending target.

The explanation for this increase is hardly surprising, as the table on this page makes clear. The unprecedented rise in military spending amounts to more than $150 billion. Increases in "non-need-related entitlements"—that is, those, such as Social Security and federal pensions, in which the income of recipients is not a significant factor in their payments—are rising at a rate much faster than tax revenues.

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[5] Some facts on debt-heavy corporate balance sheets are set forth with admirable clarity in an article by Felix Rohatyn in *The New York Review of Books,* November 4, 1982.

[6] The projected budget figures are based on the analysis in "The First Concurrent Resolution and the Budget Outlook," by James Capra, in the "Quarterly Review" of the Federal Reserve Bank of New York, Summer 1982. Some adjustments to reflect congressional action since the publication of the Capra article have been include in the budget estimates.

As the table also shows, federal grants to state and local governments and federal operations have actually been cut back. The budget cuts in 1981 and 1982 have reduced projected spending on "need-based" programs nearly twice as much as in the much larger non-need-related programs, which go mainly to middle- and upper-income groups. A lopsided example: projected food-stamp outlays for 1983 were cut by about 20 percent in the 1981 and 1982 Reconciliation Acts, while projected federal employee retirement benefits were reduced by less than 3 percent.

These facts are gradually being recognized. There is a growing if muted agreement in Congress that the projected budgets for defense and for Social Security and federal pensions should not be immune to cuts. But by how much must these deficits be reduced? We have first to define the largest deficit that would be consistent with the minimum net investment needs of the economy. Suppose we wish to have sufficient net savings available to match the rate of private investment—"capital formation"—that prevailed during the 1960s. That would, in my view, be a modest goal. But to achieve it, the deficit must, according to careful estimates,[7] be reduced to less than 1.5 percent of the GNP if sufficient capital is to be freed for investment. Such a deficit would be about 4 percent of GNP lower than the current projection of the deficit for 1985 and would amount to a reduction of the 1985 deficit by about $160 billion. That would mean cutting 16 percent from total projected government spending in 1985.

A reduction so huge may sound politically impossible. But a deficit of about $220 billion, which is now projected for 1985 if current polices continue unchanged is simply unworkable. First, it would be more than three times the largest deficit we had before 1982 ($66 billion) and would equal a record 5.5 percent of GNP. Second deficits would be rising steadily over the next three years. The projected deficits are "structural"—not the result of recession. They would occur at the same time that the economy is supposedly growing at 3 to 4 percent per year. Rising deficits during a prolonged economic recovery are without precedent in this country. (Of course, the financial imbalances that would result from such large deficits call into question whether the economy would in fact sustain 3 to 4 percent growth for the next few years. If the economy is instead flat, the deficits would be much larger.)

Thus we have created a fiscal Frankenstein monster. If and when a strong recovery occurs, that monster would be aroused to devour immense amounts of available savings. One can question whether a normal cyclical recovery from the current recession can occur in the face of this monster. What clearly cannot occur is the necessary revival of investment everyone concedes we need.

Simple arithmetic alone makes it obvious that only a few parts of the budget are, by themselves, large enough to yield the kinds of savings that will be required. I would also hope that a sense of simple equity would not lead us to put the "need-related" programs for the poor under the axe once again. Most federal operations are also unlikely targets: minimum levels of law enforcement, Treasury operations, and government statistical reporting are necessary if the government is to be run efficiently. Further reductions in agricultural subsidies, such as dairy price supports and tobacco and sugar subsidies, may well be desirable. But the amounts involved in these programs, totalling $2 billion, are small relative to the size of the problem. Cuts in grants to state and local governments could result in more decay of our public infrastructure—highways, mass transit, and the dredging of rivers and harbors, to name only a few possible casualties.

What is clear is that, along with net interest payments on government borrowing, defense (28 percent) and non-need-related benefits (39 percent) represent about 80 percent of the total budget. Social Security alone accounts for 26 percent. Most of the deficit reduction should come from these three expenditures.

Before we examine how this can be done, it is useful to look briefly at the question of tax increases. Raising taxes is clearly one way to lower projected deficits—but most emphatically, in my view, not the preferable way. Moreover, tax changes would need to be carefully drafted or they would be self-defeating. It would be irrational to propose the kinds of tax increases that directly or indirectly discourage the very investment that we are trying to promote in this grueling fiscal exercise. Thus consumption taxes in general and energy consumption taxes in particular, e.g., on gasoline, would head my list of any tax increases that might be required.

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[7] Assume that the savings incentives in last year's tax bill make it possible for gross private savings (personal, business, and state and local pension fund savings) to rise to 19.3 percent of GNP. Depreciation, or capital consumption allowances, could be expected to absorb 10.5 percent. Assume state and local deficits and net foreign investments have offsetting effects. Thus 8.8 percent is left for financing the federal deficit, residential construction, and investment in plant, equipment and structures. If the federal government deficit were cut to 1.5 percent of GNP, the residual left for net new business investment and housing would be slightly larger (0.3 percentage points) than the average for the 1960s.

The case for significant cuts in the defense budget goes well beyond the question of whether we really can spend wisely such unprecedented real increases—nearly 9 percent yearly in overall spending between 1980 and 1985 and over 14 percent yearly for military hardware. Furthermore, the decline in the inflation rate means that we should be able to buy more with the dollars appropriated for defense than was thought possible when the original plan for the buildup was put together in early 1981.

My own negotiating experience with the Soviet Union taught me that they will be far more impressed with a sustained approach to building defenses than by what they will perceive as an approach alternating between feast and famine. The Soviet Union, in any case, can plausibly assume that neither our economy nor our politics can sustain the vast increases now planned—particularly at a time when big cuts are being made in our politically most sensitive programs and when our economy is weak. Indeed it will be politically impossible to obtain cuts in the even larger Social Security and federal pension programs unless defense cuts are a significant part of a balanced "package" to reduce the budget.

But however clear one may feel the case for reduced military spending, the recent bipartisan budget effort of five former secretaries of the treasury and myself persuades me that it is unlikely that cuts much larger than $25 billion in 1985 can actually be achieved.

ESTIMATED FEDERAL GOVERNMENT OUTLAYS, COMPARISON OF 1980 TO 1985 AS NOW PROJECTED

	In billion of dollars			In share of GNR [1] (percent)		
	1980	1985 [2]	1980–85 change	1980	1985	1980–85 change
National defense	$123.9	$274.1	$+150.2	4.8	7.0	+2.2
Benefit payments for individuals:						
Need-related [3]	55.9	80.3	+24.4	2.2	2.0	−0.2
Non-need-related (social security, Federal pensions, etc.)	227.1	380.1	+153.1	8.8	9.6	+0.8
Grants to State and local governments	57.2	53.6	−3.6	2.3	1.3	−1.0
Other Federal operations	60.1	59.0	−1.1	2.3	1.5	−0.8
Net interest [4]	52.5	120.1	+67.6	2.0	3.1	+1.1
Total	576.7	[5] 967.2	+390.5	22.4	24.6	+2.2

[1] Assumes real growth of 3–4 percent in 1983–85. 1985 GNP=$3,935.5 billion vs. Reagan April 1981 "supply side" target of $4,398.1.

[2] Outlay projections are based on congressional action to date.

[3] In 1981 and 1982, the growth in these need-related programs was cut over twice as much as the non-need related (10.1 percent vs. 4.7 percent).

[4] For 1983–85, the interest-rate assumptions are those specified in the first concurrent resolution on the budget, declining to an average rate of 7.4 percent on new Treasury debt in 1985. If interest rates turn out to be higher, each percentage point over the entire three years adds about $8 billion.

[5] Reagan April 1981 spending target for 1985 was $844 billion.

3.

This brings us to our central concern—the non-need-related programs, of which Social Security is by far the largest. Some experts have testified that the financial deficits facing Social Security during the next few years—$30 billion by 1985—may be only a temporary hurdle. Higher payroll tax rates for Social Security, they point out, have already been legislated for 1985 and 1990; these, along with the rising volume of wage payments to today's baby-boom generation, may push these funds into the black by the late 1980s and 1990s. Only after the boom generation begins to retire, and that's not until 2020 or so, can we certain that the bottom will fall out of the Social Security system. Why worry today about what you may be able to put off until tomorrow?

The problem with such complacency is that Social Security funds may not be sufficient to meet the system's obligations. Each year the Social Security trustees publish three or four projections of the system's future income and outlays, the so-called "optimistic," "intermediate," and "pessimistic" scenarios. For the period before the year 2000 the variations between these projections depend primarily on assumptions regarding real economic growth. According to the "optimistic" estimate, the Social Security retirement and disability funds will be solvent by the late 1980s and thereafter. But this "optimism" (based in part on the administration's near and medium-term forecasts) assumes an unbelievable rate of sustained growth in productivity—about 3.1 percent to 3.3 percent per year from 1985 to 2005. This far surpasses any comparable period in U.S. history, even boom the years of the 1960s. The "pessimistic" scenario, on the other hand, will plunge our trust funds into deficits from which they will never recover—not in the 1980s, 1990s, or ever. The annual deficit of these two funds would exceed $100 billion by 2005; after which it would explode. And even this pessimistic estimate assumes that productivity will grow at a rate of 1.9 percent—a rate significantly higher than the 1.2 percent rate during the stagnant decade of the 1970s.

These calculations, moreover, consider only the retirement and disability trust funds. They exclude Hospital Insurance (HI, or "Part A" Medicare), the third and most rapidly growing component of the Social Security system. According to even the most favorable projections, HI will dive into the red permanently within the next two or three years. From 1990 on, HI's yearly deficit will deepen rapidly, perhaps drawing on and draining the other trust funds, should they still be solvent. If we add the problems of HI to the calculation, only the most "optimistic" projection can hope to keep Social Security in the black until the year 2000. The "pessimistic" projection—which is in fact plausible—yields a deficit projection for all three funds of a staggering $371 billion in the year 2000.

All of this may seem perplexing. Even though the members of the huge baby-boom generation are still entering the labor force or are now moving to the crest of their earning potential, our economy still cannot hope to perform well enough even to keep payroll taxes (at higher rates) on a par with retirement benefits. And it is too late to hope for population growth to do the trick. The "baby bust" that followed the postwar baby boom has ensured that we cannot expect enough growth in the taxpaying labor force to sustain the system during the next twenty years.

Why is this so? The explanation lies in the rapid and relentless growth of benefit outlays. First, Congress raised the initial benefit levels for newly retired persons (as a share of preretirement income) by nearly 50 percent during the past fifteen years. As more workers continue to retire, the aggregate cost of the system must continue to mount as well. Second, Congress has indexed all benefits currently being paid to the overly buoyant Consumer Price Index—whose yearly increases routinely exceed the yearly real-wage increases of tax-paying workers. Third, Hospital Insurance costs are climbing wildly because of the hyperinflation of health-care prices. Fourth, elderly people are living longer. Average life expectancy at age sixty-five is today one third longer than it was when Social Security was first enacted (16.6 years as against 12.3 years) and it is still rising. Finally, and perhaps inevitably, the elderly are leaving the labor force and cashing in on Social Security in greater numbers as they do so. In 1950, 46 percent of all elderly men were part of the labor force; by 1980, this percentage had dropped to 19 percent.

Therefore even if we look ahead only ten years or so, the financial integrity of Social Security is in grave doubt. In fact, it's going broke right away—contrary to all the projections of just a few years ago—and it is facing multibillion-dollar deficits. Whether the system can pull itself into solvency by 1990 depends on a race between more workers and economic growth on the one hand, and climbing benefit costs on the other.

By 2030 or 2050, the situation will surely get worse—much worse. Shortly after the beginning of the next century, the members of the baby-boom generation will begin to retire, and all the demographic variables that once helped revenues will then come crashing down on the side of costs. Whereas the size of our work force will likely remain virtually stationary at about 140 million (or even decline) after the year 2000, the number of beneficiaries will rise from 43 to 48 million in 2000 to as many as 96 million by the year 2050. By the year 2030, the proportion of elderly in the entire US population will match the current proportion of the elderly in Florida. Today, there are about thirty Social Security beneficiaries for every hundred taxpaying workers. By the year 2050, there may be as many as eighty.

Even the most"optimistic" long-run projection indicates Social Security deficits by the year 2025, a projection that assumes never-ending economic prosperity, a surge in the number of future new workers, and stagnant future life expectancies. The "pessimistic" long-run projection shows that the entire system, already sinking into deficit by the beginning of the century, will simply disappear from sight in a pool of red ink. By 2035, it predicts that the retirement and disability funds alone will need an 11.5 percentage-point boost in the tax rate—consuming 23.9 percent of the taxable payroll—just to break even. Including Hospital Insurance, the system will need to absorb fully 44 percent of each worker's taxable payroll just to break even. Without any tax increases, the annual deficit would be $16.3 trillion, or 10 percent of GNP. By the year 2050, the entire system will need to absorb over one half of each worker's taxable payroll—again, just to break even. If the size of the federal budget remains unchanged as a share of GNP, Social Security in 2050 will comprise over 70 percent of all federal spending.

As we consider long-term possibilities, much depends on demographic trends, which are notoriously hard to predict. Continued low fertility rates among women may achieve zero population growth in the US by early next century (and therefore further reduce the number of taxable wage earners), or they may not. Dramatic advances in biogenetics and in nurtition may continue to extend life expectancies (and therefore increase the costs of the system) or they may not. Again, the long-run "pessimistic" projection is, in fact, a plausible one and could even turn out to underestimate the future crisis. It simply assumes that women will continue to have not many more children than they are having now and that life expectancies will continue to improve along the trend of the last decade or two. The long-term outlook is grim according to the best projections. According to the worst, it is truly dire.

4.

The only alternative to reorganizing Social Security is to sit by while the system collapses, either through an ugly revolt of young taxpaying workers against their elders or through a catastrophic flood of deficits. Maintaining the status quo—which many politicians from both parties have pledged to do—is literally impossible, an utter fantasy. Necessity is a respectable motive for reform. But even if Social Security were able to survive indefinitely, the time would be ripe to re-examine its premises.

The system was the product of the Great Depression years when we feared that pervasive unemployment would be a permanent feature of the economy and that government accordingly had a duty to shrink the labor force by encouraging early retirement. In spite of today's recession, the prospect in the late 1980s and the 1990s is for slowing growth in the labor force and tightening labor markets. As the economy recovers, the nation will find itself needing the working skills and experience of older people.

During the Depression, welfare programs were few and skimpy; social insecurity was a fact of life for millions. In the two generations since, a great many programs have been set up for the poor, the disabled, the unemployed, the sick, and the homeless, of all ages.

During the Depression, the elderly population was 5.5 percent of the total population. In 1980, it was 11.2 percent and growing.

During the 1930s the average sixty-five-year-old had only twelve more years to live, and the retirement benefits seemed both appropriate and compassionate. As we have seen, today's sixty-five-year-old is comparatively young and has an average of 16.6 more years to live. Every study I know of indicates that for most elderly people, during most of these years, continued, active employment is the best insurance against illness and senility.

During the Depression, privately financed pension plans were a novelty, available to very few workers. Today, about half of the work force is covered by some form of private pension, with about 750 billion dollars already set aside.

Finally, the Depression made plausible the new Keynesian theory that government could restore prosperity by discouraging "excess" savings and promoting consumption. Today, we face an economy starved for savings and capable of vast excesses of consumption. In addition, during the 1930s we did not have the variety of institutions and programs (such as pension plans) that are now engaged in collecting and recycling savings. Today not only can we collect savings more efficiently but, in addition, they are recycled instaneously.

The basic idea of Social Security—providing pensions for the elderly from taxes assessed on the earnings of their children and grandchildren—answered directly to the peculiar needs of the 1930s. If we were starting fresh today, a different system would deserve serious consideration—one in which each generation of workers, individually and through public taxes and funds, saved amounts that were adequate to support its own needs during retirement. But now the important question is how to rescue what is good in the original conception of Social Security from the foolish optimism of the last decade [8] and from the perverse distortions introduced into the system during the past forty years.

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[8] President Carter, in 1978, in signing the Social Security tax legislation, said, ". . . from 1980 to 2030 the Social Security system will be sound."

We are constantly told that reforms would violate elementary precepts of common fairness and social justice. Supposedly, such reforms would amount to legalized theft from today's beneficiaries, would unfairly violate a solemn compact between generations, or would strike a cruel blow at the poor. In the next issue, I will deal with these arguments, which are based on fictions, and will suggest concrete reforms to answer the real questions of fairness raised by the Social Security system. A sounder system that will also allow for future prosperity is consistent with a fairer system that does not rob the son to pay the father, or the private worker to pay the government worker, or the poor to pay the rich. Social Security, one of the principal legacies of the New Deal, must be rescued and transformed during the next few years. Otherwise it will visit upon our children the same conditions of economic chaos that attended the system's birth.

II. The Salvation of Social Security

Social Security remains sacred in American politics while it threatens the entire economy. In the recent election campaign, practically all the candidates promised to "preserve Social Security," to "resist any cuts in benefits," and to "protect the elderly poor." No one dared to say that without major reforms—including "cuts"—the Social Security system will run huge deficits, that these deficits will push our children into a situation of economic stagnation and social conflict and create a potentially disastrous situation for the elderly of the future.[1]

Politicians cannot hide a truth this important. When a recent national survey asked workers whether they felt they would end up receiving their Social Security benefits, 84 percent between the ages of eighteen and forty-four said no. Evidently many people sense that Social Security is in very serious trouble. Why do so many politicians pretend otherwise? The do so because they fear that the voters will punish messengers of bad news, and the future of Social Security is particularly bad news.

The elderly are bound to feel threatened, betrayed, and angry if politicians speak of taking away the one thing that has sustained many of them. At the same time, younger generations tend to see the elderly as far sicker and poorer, far more disabled and homeless than they really are. Younger people also believe the elderly are more dependent on their children than they are—or think they are. A recent survey, for example, found that people below the age of sixty-five estimated that about 30 percent of the aged receive income from their children. But in fact only 1 percent of old people—possible fewer—receive their principal support from children or relatives; fewer than 5 percent receive any help that could be considered income; and the elderly are twice as likely to be providing financial help to children as to be receiving it.[2]

Social Security benefits are obviously of special importance to the elderly poor. Reforms must be carefully structured to avoid harsh consequences for those who depend on the system. But most retirement benefits do not go to those below the poverty level. Social Security is in many ways a middle- and upper-income program; it has become a political sacred cow not because of a humane concern for the poor but because of a political reluctance to impose fiscal restraint on middle- and upper-income voters. Still, if such reforms are carried out soon, they need only involve a gradual reduction in the rate of increase of Social Security benefits, giving the current working population time to adjust, and providing—through expanded private savings and private pension—need for their retirement and the savings the economy needs for its long-term health.

1. THE MYTHS OF SOCIAL SECURITY

If Social Security is to be saved, the obfuscation that has served to hide the true problems of the system must give way to informed debate. Understanding is now blocked by a set of myths—fantasies, really—about how Social Security works, whom it benefits, and how it will fare over the next decades. That the system is riddled with flaws—financial, ethical, and ultimately political—may come as a surprise to most citizens.

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[1] These economic consequences were discussed in the first part of this article in the New York Review, December 2, 1982.

[2] See Stephen Crystal's America's Old Age Crisis: Public Policy and the Two Worlds of Aging (Basic Books, 1982), which contains a great deal of useful information on the elderly and on attitudes toward them. I have also found most informative the statements and speeches of Robert Beck, chairman of the Prudential Insurance Company of America.

Myth One: The problems are not serious.—Events are rapidly undermining the myth that Social Security's financial troubles are minor and temporary. In November the retirement fund had to borrow from the disability fund—the first such borrowing in the history of Social Security. By late 1983, the disability fund will run out of money to lend and then will itself face certain bankruptcy. Like two drowning swimmers, both funds will have no choice but to reach out to grasp the third fund, the Hospital Insurance fund (HI, Medicare "Part A"), which is itself sinking fast. Unless the economy undergoes a truly miraculous recovery, providing a vast infusion of new payroll tax revenue, all three funds—the entire Social Security system—will run out of money sometime in 1984 or 1985.

Yet the myth that the Social Security system is fundamentally sound persists. According to the myth, Social Security will be saved by payroll tax increases between now and 1990, which have already been legislated, and by the fact that by the end of the 1980s the last of the postwar baby-boom generation will become taxpayers while the less numerous prewar generation will retire. Meanwhile, we are not to worry if all three funds happen to go broke before this. During the 1990s all the funds will be running in the black—so the myth goes—and can easily repay any interim borrowings from the Treasury. As for the long term, even the myth makers concede that gradually deepening deficits will begin in 2000 or soon thereafter, but we are admonished only to "monitor" the situation and to avoid "rash" solutions.

Nearly everything is wrong with this picture. As long as retired people continue to receive benefits wildly out of proportion (currently, three to five times as large) to their lifetime payroll tax contributions, plus interest, the system will remain fundamentally out of balance. In a chain-letter scheme in which everyone makes payments to someone else, not everyone can win the jackpot—unless there is an impossible acceleration in growth of the number or wealth of new players. It would take momentous economic good luck for the system to achieve a temporary balance in the late 1980s and 1990s. When the baby-boom generation retires early in the next century, the system will disintegrate.

Let us examine the future in detail. The Social Security trustees regularly publish projections of the future financial condition of the trust funds—the so-called "optimistic," "intermediate," and "pessimistic" projections. Our estimate of the imminence and severity of the collapse of Social Security as we know it depends on which of the projections we believe. As I argued in the first part of this article, the so-called "pessimistic" assumptions are not merely plausible, but, to me, are the most probable of the three possibilities. On the record of the last decade or so, the "pessimistic" assumptions look, indeed, optimistic.[3] Table I, on the opposite page, shows what we have in store on the basis of these "pessimistic" assumptions.

TABLE I.—ESTIMATES OF SOCIAL SECURITY SURPLUS AND DEFICITS [1]

[In billions of dollars]

	Old age and survivors' insurance	Disability insurance	Old age, survivors', and disability insurance	Hospital insurance [2]	Old age, survivors', disability, and hospital insurance (OASDHI) [3]	OASDHI, percent of taxable payroll [4] (in percent)
1985	$−29.6	$11.7	$−17.9	$−12.2	−30.1	−1.68
1990	−41.7	28.7	−13.0	−54.5	−67.5	−2.33
1995	−63.4	39.0	−24.4	−158.9	−183.3	−4.28
2005	−89.1	42.5	−46.6	−684.7	−731.3	−8.95
2025	−2,489.9	32.6	−2,457.3	−4,337.0	−6,794.3	−22.96
2050	−21,647.4	148.0	−21,499.4	−29,504.0	−51,003.4	−34.50

[1] The estimates are based on the Social Security Administration's "pessimistic" set of economic and demographic assumptions.

[2] Beyond 2005, Hospital Insurance costs are assumed to grow at the same rate as Old Age, Survivors', and Disability Insurance costs.

[3] These estimates include the scheduled payroll tax increases in 1985, 1986, and 1990. Without the total 1.9 percentage-point tax increase, the 1990 combined deficit would be $122.5 billion or 4.23 percent of taxable payroll. By 2050, the combined deficit would be $53,859.5 billion or 36.4 percent of taxable payroll.

[4] This is also the percentage-point increase in the payroll tax that would be required to maintain the solvency of the Social Security system.

The "pessimistic" assumptions themselves need to be examined. For the next two decades, demographics will hold very few surprises since almost every new worker by the year 2000 has already been born and can be counted.[4] What counts is our assumptions regarding economic performance, and of these, two statistics have special significance: the future unemployment rate and the future rate of real-wage growth. The former tells us how many workers are paying taxes into the system; the latter tells us how quickly each worker's tax payments are rising or falling relative to the Consumer Price Index (i.e., relative to each retired person's indexed benefits). Table II, on this page, shows both rates under the "pessimistic" projection.

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[3] Throughout the 1970s almost every "intermediate" projection for Social Security has, in the light of actual subsequent experience, turned out to be overly optimistic. I find today's widely used "intermediate" assumptions optimistic and the "optimistic" assumptions sheer fantasies.

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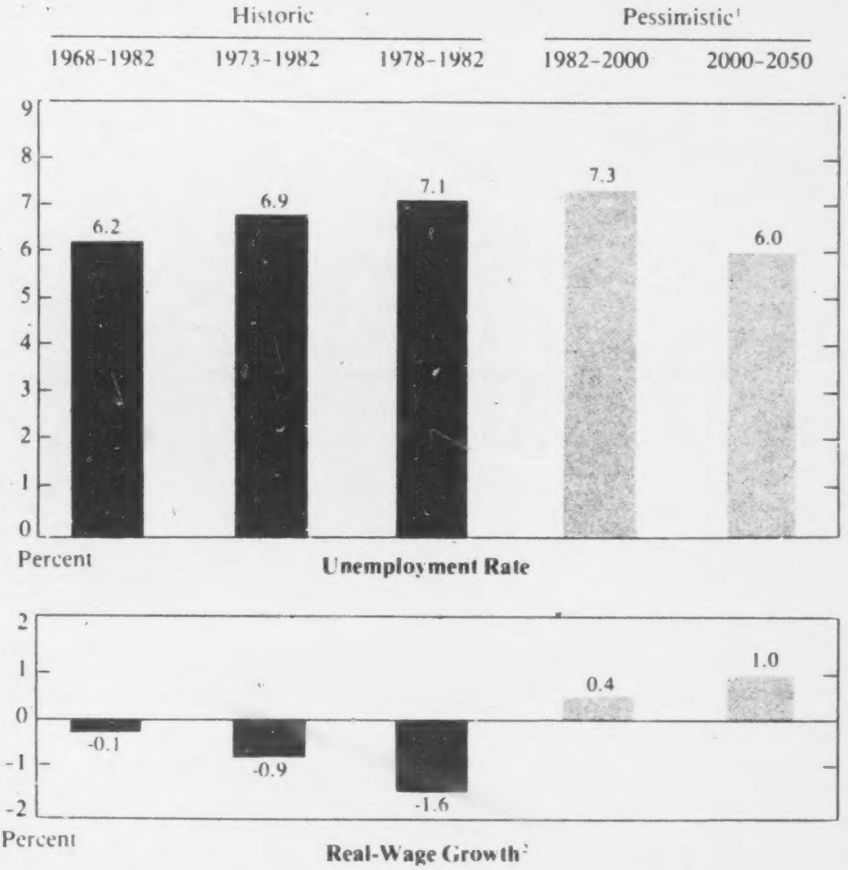
[4] One exception to the rule of "no surprises" may be immigration. Projections of the work force (and, therefore, aggregate earnings and the receipts of the Social Security system) are based on the premise that current immigration laws can and will be enforced. Either a flood of illegal immigrants or a substantial loosening of immigration restrictions could therefore significantly increase Social Security receipts by offsetting low birthrates (while avoiding the costs of child-rearing). Yet such an expansion of the work force would intensify the problem of insufficient capital information—on which I have earlier laid considerable stress.

TABLE II
The Rate of Unemployment and Growth in Real Wages: A Comparison of the Social Security Administration's "Pessimistic" Projection with Historical Data



[1] The estimates are based on the Social Security Administration's "pessimistic" set of economic and demographic assumptions. By contrast the widely used "low intermediate" (II-B) assumptions are as follows: unemployment rate, 6.3 percent (1982-2000) and 5.0 percent (2000-2050); real-wage growth, 1.2 percent (1982-2000) and 1.5 percent (2000-2050).

[2] The rate of growth in real wages is defined here, and by the Social Security Administration, as the rate of growth in money wages minus the rate of increase in the Consumer Price Index.

The single most important variable for the near-term Social Security outlook is real-wage growth. Higher real wages immediately translate into higher total payroll tax collections. The striking point about Table II is that compared with the past five, ten, or even fifteen years, the "pessimistic" assumption about real-wage growth looks rosy. If real wages between now and the year 2000 were to perform as they did during the past fifteen years (that is, to decline by 0.2 percent per year), then the Social Security deficits would be truly appalling—more than double the already unacceptable "pessimistic" figures of Table I.

We may reasonably hope that new investment and the maturing of new entrants into the labor force will make it possible to improve on the labor productivity record of the past and thus allow us at least to match the pessimistic projection. But working against this will be the fact that the era of cheap energy and "costless" pollution is over.

The near-term outlook for Social Security is much less affected by changes in the unemployment rate than by changes in real-wage growth. Looking at the projected unemployment rates in Table II, most people will, I think, conclude that the estimates, although unpleasant, are highly plausible. In recent years, most economists have come to agree that the so-called "natural rate" of unemployment (that is, the unemployment rate consistent with a rate of inflation that is not accelerating) will be substantially higher in the foreseeable future than it was in the late 1950s and throughout the 1960s (when between 4.0 and 4.5 percent seemed about the norm). Young people today are taking much longer to decide on careers. Moreover, the number of families with several earners has been rising dramatically. Wives, husbands, or grown children tolerate being unemployed more frequently, and for longer periods, when their families enjoy other sources of steady income. The "pessimistic" projection of 7.25 percent unemployment for the period between 1982 and 2000 looks favorable when compared with the current rate of 10.4 percent and the projections of most economic forecasters that the rate is unlikely to fall below 9 percent until 1984 or 1985.

Any realistic—let alone prudent—assessment of our economy's potential should take the "pessimistic" economic projection, or something close to it, as a guide for the next two decades. Further into the future the forces of demography impinge on any calculations. The central demographic question is really quite simple: as the twenty-first century wears on, how many retired (or disabled) beneficiaries will there be for every tax-paying worker? The answer to this question will depend almost entirely on the future fertility rate and on future life expectancy. More children, of course, means more tax-paying workers, which means more Social Security tax revenues for the same number of beneficiaries. Longer life spans, on the other hand, will tend to increase the number of retired people to whom benefits must be paid.

These future variables are inherently unknowable. They will be strongly influenced by the subtlest cultural trends (such as the social acceptability of having one as opposed to five children) and the most recondite medical discoveries (such as the production of cancer-fighting antibodies). Yet their influence on the future of Social Security is profound. By the year 2050, the projected "optimistic" and "pessimistic" deficits diverge sharply; an optimistic deficit of 0.7 percent of the GNP versus a pessimistic one of 10.9 percent of GNP. Over two-thirds of this difference is due to the cumulative effect of differing demographic assumptions.

According to the "pessimistic" projection, women in future decades will have only slightly fewer children than they are having now (about 1.70 versus 1.85 per lifetime). At least two current trends may actually reduce fertility rates below this "pessimistic" projection: the widespread availability of family planning and contraceptives, and the rapidly growing female participation in the labor force. Because fertility rates and economic growth have always been closely correlated, we may eventually fall into a curious sort of vicious cycle. Sustained low birthrates will put a greater burden on our system of retirement entitlements, which may in turn ensure that our economic growth remains very low.

The "pessimistic" projection also assumes that the life expectancies of both men and women will continue to improve at about the same rate as they have over the last fifteen years. Again, this is not an implausible assumption. Demographers and medical experts have still not identified a "biological limit" to human life spans. The "optimistic" assumption, by contrast, is gloomy indeed. It projects that from 1980 to the year 2060 the life expectancies of both men and women at age sixty-five will increase only by about two years.[5]

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[5] The "pessimistic" demographic assumptions are that the fertility rate will become stable at 1.7 after 2005, that male life expectancy at sixty-five will reach 20.8 years in 2050, and that

Continued

There is, of course, deep irony in the terms "optimism" and "pessimism" as we have been using them here. Many babies and short lives are not everyone's idea of an optimistic prospect, even if they brighten the annual report of the Social Security trustees. I have brought this to the attention of some liberals who resist serious changes in the Social Security system. The only future that would give the present system even the slightest chance of surviving is a future they would find abominable—a future of fantastic, limitless economic expansion, buoyant population growth, and stagnant life expectancies. Why should it be considered "liberal" to bet on such a future? Since the future of Social Security and of the economy is at stake, why shouldn't we bet on the more prudent assumptions of the "pessimistic" projection? And even if we do have a happier economic future ahead of us, we needn't worry about reluctance to increase benefits once again.

Myth two: It is "my money."—Many retired couples I know have the understandable but nonetheless naive view that they have a "contract" with the U.S. government to get back "their" money from "their" account—by which they usually mean their lifetime tax contributions, without interest. They may hold this view because terms like "insurance" or "entitlement" or "pension" are used to describe Social Security. Whatever their technical nuances, such terms mean only one thing to most people; benefits belong to the beneficiary by right. Proposals to take any of them away are both unjust and immoral.

This view—probably the most damaging myth of all—bears no relation to reality. This year's newly retired sixty-five-year-old who paid Social Security taxes during his entire working career and was an average wage earner contributed $7,209 in payroll taxes over the entire period. If we accept the estimates of longevity and inflation of the "pessimistic" projection (for the average wage earner with a nonworking spouse), he and/or his spouse will receive about $520,000, or about seventy-five times the amount that he contributed in dollars. In the first year of his retirement alone, this person received an initial benefit in January 1982 of $803 a month, for an annual amount of $9,992.[6] Put differently, in nine months the same person got back his lifetime tax contribution. This retired person or his spouse would continue to receive these payments, indexed upward annually to 100 percent of the increase in the Consumer Price Index, for a period of over twenty-five years—the average number of years that either the husband or wife would be alive to receive benefits, according to actuaries.

A more expansive definition of "my" money would include the employee's contribution, plus interest. Then the payback period would be one year and ten months. An even more expansive definition would include both the employee's and the employer's contributions, again with interest. Here, our average wage earner could get back his money in only three years and seven months—still only a fraction of the expected twenty-five-year longevity of that worker and/or any nonworking spouse.

A far more refined "present value" analysis by James Capra, Peter Skaperdas, and Roger Kubarych has just been published by the Federal Reserve Bank of New York. The analysis elaborates what should be obvious but is too often a hidden point; a so-called self-financed program that returns more than is put into it (even with interest) is a logical contradiction—or, less politely, a Ponzi scheme. Clearly someone will have to pay up. Capra et al. conclude that the program as it exists today is "fundamentally flawed." They quantify the extent to which Social Security is today a welfare program disguised as an insurance or retirement program. The person who retires and has earned average wages during his working life has a stunning "present-value ratio"—the ratio of the current cash value of all his expected benefits to his and his employer's lifetime contributions with interest—of 5.0 if he has a wife who didn't contribute to Social Security, and 2.7 if he is single.[7]

For a person receiving Social Security today this is, of course, a fabulous investment (which explains, in part, why the program is so popular). He could not have achieved a return remotely as good on any other type of "investment" made over the same period. The economy itself did not grow nearly fast enough for any "real investments" to show comparable results.

But what does this say about the argument that retired people have a moral claim on—an "entitlement" to—the level of benefits for which Congress has so generously provided? First, almost none of the person's benefits are "his money" in any sense at all. Most of them are pure windfall benefits, unrelated to tax contributions

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female life expectancy at age sixty-five will reach 29.3 years in 2050. For the "low-intermediate" (II B) assumptions, the figures are 2.1, 17.3, and 23.2, respectively.

[6] In July 1982 retired people received a 7.4 percent cost-of-living adjustment.

[7] These ratios include only retirement cash benefits. Inclusion of Disability and Hospital Insurance would make the ratios even larger.

made by him or his employer. Because people have come to expect this windfall, the government should be cautious about reducing benefits in absolute terms, at least. But that is because government should, wherever possible, avoid inflicting sharp changes on its citizens—a principle extending far beyond Social Security. However, the government does have every right to begin adjusting the annual *growth* of benefits immediately, in light of economic realities. The government has no "moral obligation" to provide windfalls forever.

Second, such vast windfalls could not continue forever, even if the government were of such a mind. Social Security proved a golden investment for today's retired people. For tomorrow's retired people it will almost certainly prove a bad investment, if not a monumental bust.

This is a matter of simple logic.

1. For Social Security to produce such vast returns—windfalls, compared to "real" investments—benefits must grow faster than the general economy. This they have done. Since 1960 total benefits have grown 3.0 times faster than GNP.

2. Because benefits are financed directly from the current tax on payrolls, and because payrolls cannot grow faster than the general economy for any appreciable period, benefits can grow ahead of the economy only if the effective rate of payroll taxes continually rises. This is what has been happening. Since 1960 payroll taxes have climbed from 2.3 percent of the GNP to 5.9 percent of the GNP.

3. But, as payroll rates rise, those paying the taxes must—as a matter of arithmetic—suffer a progressive erosion in the ratio of their ultimate benefits to the taxes they will have paid into the system. That is, their Social Security "investment" must show an ever-decreasing return.

This latter point—the ongoing erosion in Social Security's return to its participants—rises staggering questions of both solvency and fairness. People retiring today will receive their lifetime contribution (employer-employee taxes plus accrued interest) in about three years and seven months. Under current laws, today's baby-boom twenty-three-year-olds who retire in about 2025 will receive their contribution in about nine years—a 2.5 to 1 ratio in favor of those who retire today. And if future taxes are raised in order to close the huge deficits shown on Table I, the ratio in favor of today's retirees would be must higher.

What then does it mean to say that the patterns and trends of today's benefits are sacred and untouchable? It means that people retiring today have some sort of moral right to reap windfalls from a tax-benefit mechanism that will inevitably shortchange their children and grandchildren. I see no ethical logic in that position.[8]

Myth Three: The elderly are, by definition, needy.—A major obstacle to Social Security reform is the pervasive belief that old people are, virtually by definition, needy. Unwavering support for the Social Security status quo is often considered a test of one's social compassion and sense of fairness. Polls invariably show that most of us think that most old people are very poor. For instance, a Harris survey last year found that 65 percent of those under sixty-five believe that "not having enough money to live on" is a very serious problem for most of the aged, and that 54 percent believe that the aged are worse off now than they were twenty years ago.

Oddly enough, the aged themselves see things quite differently. The same survey revealed that only 17 percent of the elderly regarded low income as a serious problem for them personally, and that 58 percent of the elderly thought it was hardly any problem at all. In mean per capita income—adjusted for family size and including all sources of income—old people are doing better than people under sixty-five. Furthermore, retired people typically have lower expenses than working people (e.g., two-thirds of the elderly own homes without mortgages and they spend less on education and transportation), except for health expenses, where the elderly's disadvantage is powerfully offset by Medicare. Remember also that Social Security benefits are tax free.

The real average income of the elderly has been rising, not falling. During the 1970s, in fact, it rose more than that of the general population. The percentage of elderly people below the poverty level has fallen from 35.2 percent to 15.7 percent during the last twenty years. When benefits such as Medicare and housing subsidies are included income, the elderly population now shows a *lower* poverty rate than the general population.

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[8] Other issues of equity lie beyond the scope of this article. One relates to sex and changing patterns of life and work. For example, retirement benefit levels are increased by 50 percent when a retired person has a nonworking spouse over sixty-five (generally a woman). Furthermore, working women get a larger return on their tax investment because they live longer. Homemakers, on the other hand, do not get any benefits for work not rewarded in cash (though divorced women are treated more favorably). For a lucid analysis of these tangled issues see *The Coming Revolution in Social Security* by A. Haeworth Robertson (Security Press, 1981).

Some elderly people are indeed poor, very poor. Income averages can be deceptive. The elderly population has a somewhat higher percentage of relatively low-income people than does the general population. For the elderly with low incomes, Social Security is vital to maintaining a minimal standard of living.

This is particularly so for what Stephen Crystal in *America's Old Age Crisis* calls the "multiple jeopardy" groups—those who are over seventy-five (a group expected to grow by over 50 percent by the year 2000), widowed, single, or divorced, in poor health, without private pensions, and nonwhite. For example, the mean income of the black elderly was only 54 percent of the mean income of the white elderly in 1980.

Thus, poverty among some of the aged is a serious problem. We have just seen that Social Security is, in large degree, a welfare program rather than an insurance program. In that case, how well directed is it to the problems of the elderly poor? According to the 1980 census, those below the poverty line—today about $10,000 for a family of four—received only 9 percent of total Social Security benefits. Roughly another 30 percent of benefits go to those whose earnings range from the poverty line to twice the poverty line. By contrast, the elderly with incomes in the top 20 percent (with family income over $30,000) received about 30 percent of total benefit payments. The total Social Security outlay for such relatively well-off families is more than the combined outlays of the major need-related welfare programs—food stamps, AFDC, Medicaid, and Supplementary Security Income. In other words, because of Social Security, welfare for the well-to-do now exceeds welfare received by the poor in these welfare programs—even before one takes into account tax breaks (e.g. the mortgage interest deduction) especially designed for middle- and upper-income groups. I do not see how the claims of social fairness are met by holding inviolate the benefits of the well-to-do.

Myth Four: The elderly are physically unable to work beyond age sixty-five.—Any sensible reform package for Social Security involves raising the retirement age beyond sixty-five years (e.g., to sixty-eight or seventy years). To many, this seems heartless. In fact, polls show that a remarkable 79 percent of workers nearing sixty-five would like to continue working, if not in hard physical labor, at least part-time. But a far smaller percentage actually continues to work. A major reason is the disincentive to work built into the Social Security program: each dollar of earned income (wages) over $6,000 a year cuts Social Security benefits by 50 cents.[9] That penalty, along with the federal income tax, puts the working beneficiary into a 70 percent tax bracket or worse once he has earned over $6,000. Clearly, any coherent program of entitlements reform for the aged must make it financially attractive for people over sixty-five to work.

Two generations ago, the remaining life of a sixty-five-year-old man was an average of twelve years, and these were usually spent in deteriorating health. Today sixty-five seems comparatively young. At sixty-five, one can expect another 16.6 years of life. Every medical study indicates that responsible work, at a reasonable pace, improves the physical and mental health of most of the elderly. In Japan, most men work beyond age sixty-five and the average Japanese life span is growing faster than ours. In America only about one man in five works after reaching sixty-five.

During this period of high unemployment, it may seem economically perverse to expand the labor force by encouraging later retirement. But the economy will soon run the other way. The latter part of this century will be a period in which the growth of the workforce will slow down dramatically. Then we will expecially need the skills of our most experienced citizens.

2. PRINCIPLES OF REFORM

The myths being circulated to block reform all grossly underestimate the moral capacities of old people. Some assume, for instance, that today's elderly would demand abnormally high benefits even if that meant destroying the prospects for economic security of future generations. Politicians are therefore reluctant to antagonize what they take to be a vehement interest group. Most retired people I have talked to simply do not feel that way. In my experience, many old people have an unusual interest in and sense of responsibility toward later generations. I know of very few old people who, when informed of the facts, would hesitate to accept reasonable adjustments in their Social Security benefits.

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[9] This is a particularly regressive provision when you consider that unearned income (e.g., interest income) has no effect on Social Security benefits. In other words, a retired person with little income would be penalized for earning wages, while a retired person who is receiving $100,000 per year in interest income would not be penalized for such income.

Similarly the myth that the old see no distinction between the moral claims on benefits of the poor and of the well-to-do has, so far as I'm aware, little basis in fact. Indeed, I would guess that most rich people would be uneasy about their indexed, tax-free Social Security benefits if they knew how much their checks exceed their original contributions.

Those resisting Social Security reform are protecting not the elderly but only a fanciful vision of the elderly. The "gray power" lobbies, which make a profession of blocking reform, have a vested interest in promoting these myths. But their constituents, I believe, would far more readily face facts and support constructive efforts aimed at improving the financial soundness and general fairness of the Social Security system.

Three principles should, in my view, underlie such proposals. First, we must recognize that raising payroll taxes once again is not a solution. That approach to saving Social Security will inevitably fail. To close the deficits in the Social Security system under the "pessimistic" projection would take a payroll-tax rate of about 44 percent in 2035. This simply is not going to happen. Working people would not accept it. Even if they did, the dead hand of such taxation would drive millions of unskilled workers into permanent unemployment. We worry now that high income-tax rates may be eroding incentives to work, save, and invest, and there has been much talk of a "flat-rate" income tax below 20 percent. Yet we are moving inexorably toward a system where *payroll* taxes for Social Security alone will scoop away more—much more—than 20 percent of wages and salaries.

The approach of raising taxes has already proved its ineffectiveness. Since 1949, average wages are up 470 percent, average income taxes 570 percent, average Social Security taxes 3,960 percent, and maximum Social Security taxes 6,480 percent. The employers' share of payroll taxes will be equivalent to about 50 percent of 1982 corporate profits—against 7 percent in 1955. Today, fully one-quarter of our workers pay more in Social Security taxes than they do in federal income taxes.

And what is the result of all this tax raising? The result, as we have seen, has been to *worsen* the inequity between generations and to put off confronting the coming collapse of the system. Every new tax increase on Social Security has been followed by pressure to raise payroll-tax rates yet again. The latest proposal is to "accelerate" the Social Security payroll-tax-rate increases scheduled through 1990 but to offer an "offsetting" income-tax credit at the same time. Alas, this will simply widen the already grotesque deficit in the non-Social Security part of the budget. Ultimately this proposal is one more scheme for a self-deceiving and self-defeating tax increase.

The second principle is that we must avoid deficits in the *long term*. We are hearing much about "temporary" transfers from general revenues to "solve" the Social Security retirement and disability fund deficits. To that, I have two questions. First, what general revenues? As one senator put it: "There is no such thing as general revenues. Only general deficits." Second, if we exhaust that nonexistent treasure now, what will we use to finance the enormous Medicare deficits facing us?

Finally, any reform proposal should be equitable. Under the current benefit and tax structure, the present generation of retired people will receive a much greater return on contributions made than will those in the future. At a minimum, Social Security reform should reduce this imbalance. Equity between generations therefore requires that restraint on benefits not be postponed. Reform should also seek to protect the neediest—those who are very old, have low incomes, and are in poor health.

3.—A PROGRAM OF REFORM

How can we build a program that both assures financial solvency, without additional taxes, and satisfies the requirements of equity? Here is one proposal—offered in the hope that others will try to improve it.

One: Freeze cost-of-living adjustments (COLAs) for at least one year.—This would make up for at least some of the excesses that occurred between 1978 and 1981—because benefits were tied to the Consumer Price Index, which has an upward bias. During that period, retired people received cost-of-living adjustments that were to high by 10.8 percent, compared with those measured by a more accurate index of inflation, the personal consumption deflator. A freeze on the July 1983 or July 1984 COLA could within a year save as much as $18 billion in the cost of Social Security and other federal pension plans.

Two: Limit future COLAs after the freeze is over.—We are told that it is politically impossible to reduce Social Security COLAs. I am not so sure. Surveys of public opinion on Social Security show a great deal of confusion about these adjustments. For example, a recent survey conducted by the Gallup organization suggests that the public does not approve of automatic COLAs. Most respondents believed that adjustments ought to be annual decisions based on current circumstances.[10] Also, among those who favored automatic COLAs, a majority favored adjustments equal to the automatic adjustments in labor contracts—which, historically, have equalled about 60 percent of the increase in the CPI. Holding COLAs to 60 percent of the increase in the CPI would go a long way toward ensuring the future solvency of the system and would affect current and future beneficiaries about equally, according to the analysis of the New York Federal Reserve. Savings could reach $21 billion by 1986.

An alternative plan would be to index the increase in average wages minus 1.5 percent. An advantage of this proposal is that it would reduce the vulnerability of the system to unforeseen economic developments. Wage growth is the primary determinant of how fast the Social Security system's income from payroll tax revenues will increase, while COLAs are an important factor in how fast benefit payments will increase. If COLAs were limited to the increase in wages minus 1.5 percent, it would prevent a repetition of the expericence of recent years in which rapid growth of the Consumer Price Index compared to wages depleted the Social Security system's cash reserves even more quickly than would have been the case otherwise. In fact, this proposal for wage indexing could save $18.7 billion by 1986, almost as much as indexing to 60 percent of the increase in the CPI. However, in the long run the savings are probably less than half of those that would result from indexing to 60 percent of the Consumer Price Index. Indexing to wages minus 1.5 percent may be a little like buying weapons to fight the previous war. On the other hand, it is far preferable to the current method of full CPI indexing.

A freeze on cost-of-living adjustments and lower future COLAs need not hurt the poor. For those who receive benefits under Supplementary Security Income (SSI), the welfare program for the aged and disabled, the loss in income would be made up dollar for dollar with higher SSI benefits. Also, the restraints on COLAs could be applied selectively—they could exclude, for example, the Social Security beneficiaries who receive the smaller monthly benefit checks. By whatever means, we must continue to provide adequate benefits to the poorest, oldest, and sickest.

Three: Tax those benefits that are received in excess of contributions.[11]—For every other retirement program, whether private or public, any benefits that are received in excess of employee contributions (whether they are the result of interest on those contributions or represent the employer's contributions or both) are subject to federal income tax. It's unclear why this principle has never been applied to Social Security.[12] Taxing benefits in this way would have a number of advantages. In the long run it has the largest effect of any proposed change except for the indexing reforms. It also reduces the imbalance in the returns on contributions between those who are now retired and those who will retire in the future. Finally, the proposal has no perceptible effect on the aged who are in serious need; their incomes are not large enough to be subject to income taxes, especially in view of the extra tax exemption available to the elderly.

Four: Selectively lower initial benefits for retired persons.—When someone reaches retirement age, a calculation is made in which the lifetime monthly earnings on which he paid Social Security taxes are put into current dollars, or indexed, and then averaged. If he is single, he will receive, in 1982, 90 percent of his first $180 in average monthly earnings, 32 percent of all average monthly earnings between $180 and $1,085, and 15 percent of average monthly earnings between $1,058 and $1,258 (the latter figure represents the maximum possible average monthly earnings on which someone retiring in 1982 could have paid Social Security taxes). We could cut future benefits, while still protecting the poor, by lowering the 15 percent figure or both the 15 percent and the 32 percent figures, which apply to the upper-income categories. This would reduce the replacement rate (the percentage of pre-retirement wages that are "replaced" by Social Security benefits) for those retired people who had a record of high earnings.[13]

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[10] I have been unable to find a single major corporation that provides automatic, 100 percent indexing for its pensions. Most provide no indexing at all, except on an ad hoc basis.

[11] In the past, some have suggested taxing 50 percent of benefits, under the assumption that the employee contribution was taken from incomes before taxes and that the employer contribution was tax-deductible. Such a proposal only perpetuates the myth that lifetime employee-employer taxes are equal to benefits.

[12] Curiously, on private pension plans, the retiree pays taxes not on contributions coming in, but on everything going out. On Social Security, it is the reverse.

Five: Raise the retirement age by at least three years, to age sixty-eight, on a gradual basis.—Adding three months per year starting in 1990 would significantly improve the long-term financial status of the system.

Even with eligibility shifted to age sixty-eight, the average retired person would enjoy benefits for a longer period than did his parents or grandparents. Life expectancy has increased at a rate of about one year per decade. Many of the poorest elderly—those subject to the multiple miseries of low income, no assets, and poor health—are often unable to find work as they approach their sixties. They are often unskilled, and employers are unwilling to train them. I suggest *not* raising, and perhaps even lowering, the eligibility age for SSI as well as increasing SSI benefit levels in order to protect this group.

Six: Once these reforms are made, bring civil service workers into Social Security.—Right now the retirement system for federal employees is 2.5 to 3 times more generous than are pensions for private workers. The entire federal pension structure should be rebuilt from the ground up, providing a pension plan no more nor less generous than private plans. While cashing in on unusually generous early retirement benefits, over 70 percent of government pensioners now launch second careers that make them eligible to tap into Social Security. At the same time excessive Social Security benefits are paid to retired federal employees who have worked only the minimum time to enable them to qualify for Social Security. This is not only unfair, it's a waste of money.

If we being civil servants under Social Security, the effect on Social Security solvency during the next few years would be substantial, since the system would receive an infusion of tax revenues from the new participants but would not have to pay additional benefits for a while. In the long run this change by itself would simply make Social Security an even larger welfare program with more beneficiaries. Bringing federal employees into Social Security is an inevitable part of a much-needed reform of our federal pension system. However, because the proposal would have salutary effects in the near term, I fear that it may be used as a quick remedy instead of a long-term cure. Consequently, a program for reform of Social Security should include federal employees only if it is part of a comprehensive revision of both Social Security and the federal employee retirement system.

Table III, below, shows the effects of these various reforms in achieving the goals of solvency and equity for the pension system. One result is that the system would become solvent, i.e., would be able to meet all its obligations, with no future increases in the tax rate. In other words, the total savings from these reforms about equal the currently projected deficits through the year 2000.

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[13] According to the Social Security Administration, net replacement rates (after taking into account taxes and work expenses) for maximum wage earners are much higher today (42 percent for a retired single person and 57 percent if he or she has a nonworking spouse) than they were under the original 1935 Social Security Act, where the net replacement rate was 35 percent for both single and married retired people. Since these are usually the people with the highest post-retirement incomes, reducing replacement rates to maximum wage earners would protect the needy. Another way to do the same thing would be to freeze the so-called bend points—$180 and $1,085—for several years, since under the current law these are raised every year on the basis of growth in an index of average wages.

TABLE III.—EXTENT TO WHICH VARIOUS REFORMS ACHIEVE GOALS OF EQUITY AND SOLVENCY (NO DEFICITS AND NO TAX INCREASES BEYOND 1983)

[Note that through 2000, the percentage of payroll saved by the combined reforms roughly approximates combined estimates of projected deficits]

Reforms	Solvency goals								Equity goals	
	1986 savings		1990 savings		2000 savings		2025 savings			
	Amount (billions)	Percent of payroll	Amount (billions)	Percent of payroll	Amount (billions)	Percent of payroll	Amount (billions)	Percent of payroll	Intergenerational equity: Return on contributions to present versus future retirees	Intragenerational equity: Proportion directed to the neediest
1. One-year COLA freeze	$12.9	+0.7	$7.7	+0.3	$0.7	0.0	0.0	0.0	Improves	Can improve.[1]
2. Indexing benefits to 60 percent of the CPI.	21.1	+1.1	67.3	+2.3	235.5	+4.0	$3,211.8	+10.9	No change	Can improve.[1]
(Indexing benefits to wages minus 1.5 percent.	(18.7)	(+0.9)	(32.9)	(+1.1)	(97.7)	(+1.6)	(1,300.2)	(+4.4)		
3. Taxing benefits in excess of employee contributions.	10.6	+0.5	55.0	+1.9	94.9	+1.6	650.9	+2.2	Improves	Improves.
4. Alter initial benefits calculation	1.0	+0.1	2.5	+0.1	33.9	+0.6	503.0	+1.7	Worsens	Improve.
5. Raise the retirement age	0	0	1.4	0	77.7	+1.3	473.4	+1.6	Worsens	Can improve.[1]
6. Coverage of Federal workers	6.9	+0.4	10.3	+0.4	20.2	+0.3	88.8	+0.3	No change	No improvement.
Total savings achieved by reforms	52.5	+2.7	144.2	+5.0	462.9	+7.8	4,927.9	+16.7		
Solvency goal, i.e., currently projected deficits:										
OASDI deficit[2]	−33.7	−1.7	−59.4	−2.05	−119.8	−2.02	−2,929.2	−9.9		
HI deficit[2]	−20.4	−1.03	−63.1	−2.18	−364.0	−6.14	−4,438.1	−15.0		
Total OASDHI deficit	−54.1	−2.73	−122.5	−4.23	−483.8	−8.16	−7,367.3	−24.9		

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[1] Assumes that change will be made, if needed, to Supplemental Security Income (SSI) to offset any restrictive effects on the neediest recipients or, possibly, that in the case of the COLA proposals, the options would be structured to exclude beneficiaries with the lowest wage histories.

[2] These deficit projections are based on current tax rates and exclude the 1.9 total percentage-point increase in the payroll tax rate which would occur as a result of scheduled tax increases in 1985, 1986, and 1990. These estimates are also based on the "pessimistic" economic and demographic projection.

Seven: Reform Medicare and reduce medical cost inflation.—Even if all the foregoing reforms were carried out, as we can see from Table III, there would still be a deficit in 2025, largely from Hospital Insurance, equivalent to 8.2 percent of taxable payroll. This requires that we go further, to reform Medicare. We have seen how swiftly rising Medicare deficits are a driving, even dominant force in prospective Social Security deficits. The Medicare program is the fastest-growing part of the Social Security system. Between 1972 and 1982, outlays for the Hospital Insurance trust fund increased more than five-fold, from $6.5 billion to $35.7 billion, 2.8 times as fast as GNP; disbursements per beneficiary increased 300 percent since 1972. Under the projections in the most recent report of the Social Security trustees, expenditures in the future are expected to increase between about 3 and 4 times as fast as GNP. Prospective costs are immense, especially in view of the huge increases in the number of people over seventy-five and the emergence of new life-saving technologies. The latter problem is already illustrated by the estimate, according to experts, that between one third and one half of Medicare payments have gone to keep elderly people alive in their last year of life.

Ultimately, the runaway expansion of Medicare can be slowed only by reducing the rampant inflation in hospital and other medical costs. This inflation is partly fueled by perverse incentives and archaic insurance arrangements that shelter the medical sector from normal competitive forces.

While reform of the Medicare program is beyond the scope of this article, the entire structure needs comprehensive reorganization with new incentives to reduce costs. For example, from the standpoint of the providers of health services, we have a system in which costs are determined retrospectively (that is, it reflects the sentiment, "You don't get a dollar unless you spend a dollar"; "The more you spend, the more you get"). I would strongly support more experiments with prospective price systems, based either on unit prices for specific forms of care or on inclusive budgets for a package of services, provided through a hospital or local community, that would be negotiated in advance. From the standpoint of the patient (and his employer), there are now few incentives to keep costs down. Thus such notions as increased deductibles and co-payments, voucher systems, and treating some part of employer contributions for medical benefits as ordinary income for tax purposes must receive serious consideration.[14]

4.

By conventional political standards this program of reform may seem impossible. But without such a program the Social Security system, and economic growth itself, will become impossible. That will tend to alter political conventions. The real question, therefore, is whether we possess the wit and determination to change our own politics or whether we must wait until chaotic change is forced upon us, including a full-fledged rebellion by young workers, crushed by taxes, against the entire notion of supporting the elderly at a decent level of income.

Republicans and Democrats have both shared amply in the decisions which turned a sound, though controversial, program into a vast scheme of welfare for well-off citizens. The radical distortions in Social Security have had strong bipartisan support. The huge benefit increases of the early 1970s were supported jointly by Wilbur Mills and Richard Nixon. And both parties have failed to inform the public about the system's problems—and have done much to give false reassurance about its future.

There is no partisan method to save the system. The rescue of Social Security is not a liberal or a conservative cause; it will depend on combining a realistic understanding of fiscal deficits with a humane sense of social fairness. Politicians are thoroughly convinced that any party or faction proposing serious reform will face certain annihilation at the polls. Inaction may remain smart politics for a few more years, but I am not so sure. When the system comes crashing down, smart politics will be small consolation. Thus Social Security poses one of the deepest challenges to democratic politics in our history, a challenge above all to the middle- and upper-income citizens of this country who largely determine the course of public policy. They are the ones willing to stake the future of Social Security on absurdly optimistic assumptions, and the ones to whom the system dispenses a big share of its welfare. The excessive Social Security and public pension benefits that flow today to the relatively well-off are, literally, stealing capital from tomorrow's citizens and making cuts in government programs to the poor irresistible.

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[14] Unlike direct changes in the benefit levels of cash retirement programs, for which effects on outlays can be estimated with some precision, proposed changes in Medicare will have largely indirect effects on benefit levels (e.g., from the incentives provided by higher deductible amounts). The resulting effects on total outlays cannot be precisely predicted.

I can imagine few ethical goals more important than fairness to our children and fairness to the poor. If the children and the poor deserve better treatment, the sacrifices must come from those who are left—the adults who are relatively well off. I suspect that many readers of this article fit that category. It is from us that moral leadership is required. Someone must step forward and say, "Cut my welfare. I am willing to have my ox gored."

There is, I think, some cause for hope. With the election behind us, Social Security now has a chance to become again a "problem" rather than an issue to be exploited. For example, a bipartisan group of several hundred people—former cabinet officers, business leaders, and academics—is about to make a nationwide appeal for balanced fiscal reform to the Congress and to the president. But this is only a start. Americans who are better off must now lead by example—by making sacrifices for the common interest. Otherwise, although America will of course survive, it will be a poorer country.

Chairman GIBBONS. I had forgotten about the word MEGO: My Eyes Glaze Over. I think it probably describes the dilemma we find ourselves in here in the Congress as well as anything, because America really never having been used to floating exchange rates or even the process of changing our currency. I have noticed that all of us kind of go bleary-eyed at the exchange window and tend to take whatever is offered us when we start to exchange our dollars.

We have always been proud of the fact that we had a strong dollar, but yet, as you all have said, you can have an overly strong dollar. It is not healthy for us. It is not healthy for the world economy.

Really the world is experimenting and how you buy and sell currencies is what we are talking about. I think maybe to open this discussion a little more we ought to have an explanation, how are currencies bought and sold on a world market?

How does this actually take place? What is the volume of currency that is bought and sold? How is the price fixed, or established I guess is a better way of putting it, because it is certainly not very fixed.

Mr. BERGSTEN. I could take a crack at that

Chairman GIBBONS. Go ahead.

Mr. BERGSTEN. The magnitudes, first of all, are enormous. The Federal Reserve Bank of New York, which is the official U.S. operator in the exchange markets, has done some surveys of the volume of transactions. Already 4 or 5 years it was running on the order of $25 billion to $35 billion a day just in the U.S. market, and it is not clear the U.S. market is the biggest in the world compared with London and increasingly a number of foreign exchange markets around the world.

There have been recent estimates, but they are no more than guesstimates, that suggest that each day we get more than $100 billion worth of transactions in the foreign exchange market.

Chairman GIBBONS. Is that $100 billion worth of transactions in the foreign exchange market—I am trying to define it—is that in U.S. dollars?

Mr. BERGSTEN. That is a dollar equivalent of all the currencies that are traded. Now, the dollar itself still accounts for something on the order of 60 to 70 percent, probably, of all international financial transactions. On one side or another of more than half the transactions is the dollar because it is still the main transaction currency, main vehicle currency, et cetera, but the total that I give you is not just dollars. That would be the dollar equivalent.

Chairman GIBBONS. $100 billion in dollar equivalence. Of that $100 billion, 60 to 70 percent of it is dollars?

Mr. BERGSTEN. Dollars would be on one side of the transaction, buying and selling dollars. When people move from dollars to deutschemarks, they usually move from sterling to dollars and dollars to deutschemarks rather than moving directly. That is because of the much greater liquidity of the dollar markets, the lower transaction costs, the greater efficiency of moving in dollars.

So even when you move between currencies of neighboring countries, Britain and Germany, France and Germany, very frequently the transaction goes through the dollar, and that can affect the dollar cross rates vis-a-vis the different currencies.

Mr. PETERSON. Mr. Chairman, might I take a crack at a piece of that?

Chairman GIBBONS. Sure.

Mr. PETERSON. Part of the changing structure of the world economy that I would urge you to look at is to set up a set of columns on the one side like share of exports, share of imports, share of investments, share of everything, and then on the right-hand side. I would suggest showing the share of those that are denominated in dollars, and what you will tend to find is that the dollar is a more important currency in terms of the way it is denominated in all forms of commerce than its substantive importance today in the world economy.

That, in itself, creates a certain demand for dollars that in turn strengthens the dollar, so that if you could work out a system where more transactions were denominated in other currencies—and I would pick the yen as one of the most important ones there, so that its importance in world commerce, not just speculation, Mr. Chairman, but buying and selling products were more appropriate to its real importance, that in and of itself would make a difference.

Chairman GIBBONS. You know, when I first got acquainted with this, I thought that everybody was turning things into dollars as a courtesy to me, so that I would understand it better. Now I realize from going around the world and talking to people, people think in terms of dollars. They are constantly relating their currency to the dollar.

Mr. PETERSON. Precisely.

Chairman GIBBONS. And that means that not only are we the real bankers of the world but we are sort of the psychological bankers of the world. Everybody is constantly comparing their position to our dollar. Therefore it is very simple for them to talk in terms of dollars. Is that what you mean?

Mr. PETERSON. Precisely. And part of the change I think is to try to make more of the transactions denominated in other currencies, in particular the yen.

The second point I would make, Mr. Chairman, is while I think the extent of the activity in the currency markets is one important indicator, another way that I tend to think of it is to say that the United States is really selling two kinds of products. One is financially denominated products, and the other is what you might call trade denominated products.

In a sense, what has been going on is that our financially denominated dollar products, with very high real and nominal interest rates, have become much better buys than have the American manufactured products, and indeed, Fred, in an ironic way, the more attractive our financial products become, because of the very high interest rates and the yield, the less attractive our manufactured goods become, because the dollar then goes up in value. So think of it in terms of supply and demand for dollar denominated instruments as well as the currency markets.

Mr. BERGSTEN. It is almost an extension of the traditional theory of comparative advantage. The United States has a comparative advantage in its highly efficient capital markets, and that drives up the price of those assets but adversely affects, as Mr. Peterson says, manufactured products like Caterpillar tractors. There is a dramatic illustration of Mr. Peterson's points about the dominance of the dollar in trade finance, which relates to Japan. He made the comment in his statement that Japan has a junior currency or is really a junior partner on the financial side. It is really startling.

The Japanese did a study of this a couple of years ago, and found that only 3 percent of all Japanese imports were financed in yen, and only 30 percent, as I recall, of their exports were financed in yen. Practically all of the rest was financed in dollars. Here is the second most powerful economy in the world financing almost all of its imports in dollars.

Now, that, of course, gets back to another point Mr. Peterson made. An excessively strong dollar is no big bargain for Japan either because all of their imports then cost them an enormous amount, given the dollar denomination of those imports. It really is a striking illustration of the asymmetry between the economic role of the United States and Japan, just to take those two, and the financial role.

The Japanese exports of manufactured goods are almost as high as ours, the Germans a little higher actually, but there is this enormous disparity on the financial side, and financial markets take a long time to equate to underlying economics.

The pound sterling stayed strong for 50 years longer than it had any business doing, so inertia is very strong, but it is a major source of the problem.

Chairman GIBBONS. Go back now and explain to us a little more. How is this trade in currency actually carried on? What I am leading up to is, has the trade been rigged in any manner? But describe to me how it is carried on.

Mr. BERGSTEN. Well, the vast bulk of that $100 billion or so, in fact almost all of it, is carried out by private transactors who need foreign currency for trade transactions, or for investment activities. Take the case I just mentioned. Japan is importing, paying for almost all of its imports in dollars. That means that the big Japanese trading firms, Mitsubishi, Mitsui, whoever it is, have to have dollars to pay to Saudi Arabia or the Exxon Corp. to buy oil coming into Japan. So if they don't earn enough dollars from their own export activities, they are then in the market buying dollars to finance their imports of oil, food, raw materials, whatever it may be that they are importing into Japan. Likewise, when Japanese——

Chairman **Gibbons**. Because the Saudis won't take anything but dollars, is that it?

Mr. **Bergsten**. They both price in dollars and demand payment in dollars for their oil, right, and that is the case for somewhere on the order of two-thirds to three-quarters, probably, of world trade.

Chairman **Gibbons**. In other words, the Saudis just don't want to have to take the risk of exchanging yen for dollars in some other market, so they demand to be paid in dollars, and that is true in other markets, in other products?

Mr. **Bergsten**. Right.

Chairman **Gibbons**. That Japan has to import?

Mr. **Bergsten**. That is right.

Now look at the financial markets. I mentioned before that when Japan liberalized its restriction on capital outflow, there was this enormous pentup demand of Japanese investors to get dollar assets, sterling assets, whatever. To do that they first of all have to buy the dollars or sterling, so they convert yen into dollars. That pushes the dollar exchange rate up. Those dollars are then used to buy equities in the New York stock market, U.S. Government bonds on the safe haven theory, those are the safe things to be in in a troubled world, et cetera.

So whether it is trade transactions or financial market transactions, the person who is interested in buying goods or financial assets denominated in dollars first sells his own currency for dollars and then uses those dollars to carry out the economic transaction. Because the dollar is so pivotal to financing all this, that creates in most periods, as Mr. Peterson says, a lot of demand for dollars.

I should mention just one footnote. In periods when the dollar itself comes under pressure because of poor economic policy here, or because of this deterioration in the trade balance we are now expecting, it can cut the other way. The fact that there is a huge stock of foreign holdings of dollars also means that there could be a lot of selling out of that overhang, as it is sometimes called, and put excessive downward pressure on our currency.

That in fact happened in 1978. You remember when the dollar was so weak and under constant pressure and then the headlines in a somewhat asymmetical way did say every day "dollar plunges to new low." That was in part because people were diversifying, as it was called in polite company, out of the dollar into other currencies because the future value of the dollar was suspect, so the fact that the dollar is so pivotal to world finance and there is so much of it held around the world. In most times, when there is a normal buildup in holdings and confidence in the United States, it does add strength to the dollar, but it can cut the other way, and also undermine our own currency strength.

So on that count, too, there is some reason to do as Mr. Peterson was suggesting, have a greater international sharing of the financial responsibility.

Mr. **Peterson**. Mr. Chairman, there is one other aspect in a long agenda that I would suggest seriously for your consideration. This last trip to Japan demonstrated something to me that I had not fully understood, and perhaps all of your members don't fully understand either. What was interesting to me, Fred, was to observe the way that the Japanese have, as an instrument of high national policy, I would say rather low interest rates.

These low interest rates in turn are not terribly attractive in terms of attracting money, but there is a tendency in Japan to insulate its capital markets from the rest of the world as a way, I would say, Fred, of controlling their own domestic economy, making it attractive to invest, for example, on the part of companies, keeping inflation down, money supply under control, whatever all the reasons are.

Now, one of the things I said as politely as I could to the Japanese, when I was there, I think there is another asymmetry here beyond your currency being junior but you being senior. I said I find it rather interesting that on the one hand you want full access to the manufactured goods markets of an open trade world, but you are insulating, in a sense, capital which, after all, is one of the major products you have. Your savings rate is very high.

It seems to me a bit asymmetrical to be insulating your capital markets while you insist on taking advantage of the world's manufactured goods markets. So it seems to me, Fred, that another reason that some of these instruments are not yen denominated is that it has been an instrument of national policy to make it difficult and relatively unattractive to invest in some of the yen-denominated instruments.

Let me put it to you this way. Did it ever occur to you that it is a bit of an anomaly that the capital centers of the world are New York and London but not Tokyo? Why should Hong Kong be such an important capital center of the world when the savings are in Japan? Why should Singapore be getting so important?

One of the reasons for that, Mr. Chairman, is that it has not been Japanese national policy to encourage the growth of that area as a financial center, as a service center, so there isn't any way you can divorce the yen and its importance from the Japanese domestic policy of insulating its capital markets from the rest of the world, and I would urge you to look into that subject.

Chairman GIBBONS. Why has it insulated its domestic markets? What purpose is served?

Mr. PETERSON. I suspect that part of it is cultural. Fred would know more than I. Part is a very strong desire to control the destiny of its own economy. And, you see, if you have a situation, Mr. Chairman, in which money can come sloshing in and out on a more or less free basis, as it is in the United States, you have, to some extent, lost an important element of control over the destiny of your economy.

The money supply, for example, the availability of savings to be invested where they want to invest them, so this view of insulating capital markets is perhaps part of a hangover effect of an insular view that many of us who are friends of Japan, which certainly I consider myself to be, an insular view of itself in the world economy. Part of Japan's growing up that must take place is to take a much more senior role on foreign development and aid, for example, to make its currency far more a senior currency, and to treat its capital markets with the seniority that they deserve.

Chairman GIBBONS. Do you think the Japanese understand this?

Mr. BERGSTEN. Could I amplify, just to answer that question, what Mr. Peterson said? This is not a uniquely Japanese problem. Other countries whose economic importance has risen substantially in the postwar period have also faced something of the same problem with something of the same response.

Germany was the first case in point. During the 1960's when Germany became the second economic power in the world, its exports of manufactured goods in fact exceeded ours by 1970, there developed a lot of pressure to hold the Deutsche mark and use the Deutsche mark as an international currency.

The Germans resisted on exactly the same grounds that Mr. Peterson is indicating for Japan: A fear that internationalization of their currency would undermine their ability to manage their domestic economy, a fear they were too small.

The same thing for the Swiss, whose currency has always been sought as a refuge currency internationally. They said, "But we are too small. If we permit our currency to be used outside of our borders, we lose control." For Switzerland, there is some justification for the view. For Germany there is not much, and they have in fact long since gotten over it and now the Deutsche mark plays an effective role.

For Japan there is almost no justification for the view, and it is a hangover which exists in other areas too. We see it in trying to liberalize their markets for particular manufactured products that they say are too small, vulnerable, and can't take the opening up to the rest of the world, but it is particularly clear in this financial area.

May I say our Institute, that Mr. Peterson referred to, is just now completing a study of the evolution of the multiple-currency system. What are the facts about the increased currencies other than the dollar? What are the implications of that for exchange rates, for finance? We hope to publish that early next year. I hope it will lay out some proposals and analyses that can underly answers to questions like this.

Chairman GIBBONS. One of the questions that first comes to my mind is, should we go back to the import surcharge?

Mr. PETERSON. As one of the authors of that proposal, I would put that down the list quite a ways. I would hope we could achieve it in some of these other ways, Mr. Chairman.

Chairman GIBBONS. We don't have much time.

Mr. BERGSTEN. There is one point to mention. I would share Mr. Peterson's conclusion. There is one point to mention, which is that a U.S. import surcharge or a Japanese export surcharge that he mentioned could have a perverse effect.

If the United States were to put on an import surcharge, the objective of the exercise would be to improve our trade balance, and assuming that it achieved that, or that people believed it would achieve that, it might promote——

Chairman GIBBONS. Run our currency up more?

Mr. BERGSTEN. Yet a further strengthening of the dollar. In fact, in theory you would get a total offset and the surcharge would be offset by a stronger dollar with the same amount, no net gain in your trade balance. Of course, that didn't happen in 1971. The reason, I think, was the unique circumstance in which the United States put on the surcharge. It did so in the context of eliminating dollar-gold convertibility and saying that the policy objective was to get a revaluation of other currencies, and with that sort of overriding objective, the surcharge was viewed as a tactical instrument in that direction, so that the perverse effect did not occur.

It would be very hard to cook up that same kind of scenario now, given the fact we are in a flexible exhange rate world and particularly given some current ideologies about stating what currency objectives ought to be, so I think it would be tough now, and if you didn't do it in the right context it could in fact backfire. The same with the Japanese export surcharge, which would presumably weaken the outlook for their trade balance, could weaken the yen even further.

Chairman GIBBONS. Mr. Pease.

Mr. PEASE. Thank you very much, Mr. Chairman.

I think this has been extraordinarily good testimony this morning. I am certainly grateful that I have been able to be here and listen to it.

I have a number of questions, starting with the mechanics of exchange rates. If the value of the yen is 250 to the dollar today, and it is 240 to the dollar tomorrow, where is that change accomplished? How is it accomplished?

Mr. BERGSTEN. Well, technically it is a very efficient market. As I mentioned, huge volumes are transacted every day, and the way it would change is in a modest alteration at the margin of the supply and demand for the currency. If people start to believe, for example, that the yen is going to rise, for reasons of underlying trade balances or whatever, they may start to speculate in yen, and a few billion dollars shifting from U.S. Treasury bills to Japanese treasury bills means selling of dollars, buying of yen, which may alter that balance and push the yen up from 250 to 240.

Just on the trade side, if there is going to be this huge deficit in U.S. trade balance next year, it means that Americans are going to have to be buying more foreign currencies in order to purchase those foreign goods, the imports that are going to be rising so rapidly, which are very price attractive now, like Koimatsu tractors, and that means they would be selling their dollars for Deutsche marks or yen or other currencies, and that too would tilt the balance at the margin of supply and demand, but it really is a very efficient market in technical, economic, and market terms, and you can alter the marginal balance and get some important moves in the level of the currency.

Mr. PEASE. In his testimony, Mr. Elder said that the goal of the United States should be a freely traded international yen. That suggests that it is not freely traded now; is that correct?

Mr. ELDER. Well, sir, our research, and the testimony of my associates here, certainly leads to that conclusion. When we have an economy in which controls are periodically placed upon inflows and outflows of capital there—yes, we believe there is a lack of freedom in trading.

Mr. BERGSTEN. I would demur slightly from that. I think there certainly are some disincentives to invest in the Japanese capital market now that ought to be eliminated, and there have been several lists published by Japanese experts themselves. I think the problem really is a little deeper than that, and, again, it goes back to Mr. Peterson's point about the junior nature of the Japanese capital market.

For this whole postwar period, the Japanese capital market has really been incubated. It has not been a part of the global capital market. It has not been subject to the same competitive pressures, to improve, become broader, deeper, more resilient, et cetera. In fact, it has been heavily tied to the commercial banks buying government debt, stashing it away in the vaults, no active markets in T bills, in bonds and notes like we have here.

I basically think it is an underdeveloped capital market, so even if they waived away all restrictions that might exist, there would be much less appeal to invest in yen assets than there ought to be, given the sophisticated and expansive nature of the economy.

I made the point before that when they liberalized their capital controls 2 years ago, they gave Japanese investors access to trillions of dollars worth of dollar, sterling, deutschemark securities, et cetera, very attractive assets out there.

At the same time they did to a very large extent open their capital market to investment from abroad, and there has been a lot of it, although not nearly as much as the outflow. But the reason the net effect has been so much in favor of capital outflow from Japan has been that the Japanese capital market simply is not that attractive to foreigners in terms of liquidity, and the array of assets that are available.

You know, in our markets—Mr. Peterson can elaborate on it at length—you have such a wide range of assets, you are confused. There are so many things you have a hard time studying what to go into. You have the opposite problem in Japan. Suppose you said today, "I want to speculate in the yen, I think the yen is going up." It is not as easy to find an attractive market yield in liquid assets in Japan, as should be the case.

I think more than direct controls, it goes back to the more underlying problem of having had a very isolated capital market. That is changing now, but given the inertia and the time it takes for these things, I am afraid it is going to be some time until the Japanese capital market is at a par not only with our own but with its own role in trade affairs.

That is why I make what is, for me, a heterodox proposal. I am very market oriented in all of my analyses and policy advice, but in this case, because of the structual lag of the Japanese capital market, I do feel that an element in the solution to the immediate problem has to be some limitation on their outflow of capital—if you want to view it in a structural sense, until their capital markets catch up and can attract inflow enough to provide a balanced structure. That is the only reason I suggest limitations on their outflows, not that I have any love for controls, far from it.

Mr. PETERSON. Congressman, let me suggest an analogy to you. In the MITI trade area, I am sure you are aware of so-called administrative guidance in which there is a kind of infrastructure, shall we say, to put a pleasant word on it, of a set of guidance procedures, approvals and so forth that take place that at the implicit but still very effective level have in times past constituted barriers to the flow of products.

Well, while I think, Fred, in fairness to the Japanese we should point out that there has been a lot of liberalization on the capital side compared to what it used to be, still if you compare carrying out financial transactions in Japan with carrying them out in the United States, there is still a very significant difference, and one of them is in this area of administrative guidance, only this time not in MITI.

But in the finance ministry, if you want to set up a new instrument or if you want to get something approved or a new kind of investment, or you want to be approved as someone who can borrow, there are a long set of procedures that you have to go through that injects a certain amount of grit and nonlubricant, shall we say, into the process of making investments. So another agenda item for you to look at is to go through the process of how investments indeed would be made in Japan, and I think you will find that while there has been a good deal of progress, due to this fear, this sense of insularity, there are many more capital restrictions in Japan than there are in the United States.

Mr. PEASE. Many people that I talk with, my constituents, are looking for conspiracies, especially on the part of the Japanese. Are the Japanese deliberately making access to their capital markets easier at a slower pace than they should, in order to keep the value of the yen low?

Mr. ELDER. Mr. Pease, let me respond in general terms and then my associates will follow up with technical explanations.

To frame the question: we are not here to accuse the Japanese of undertaking any particular activity to keep the yen undervalued. We need to make that clear at the outset.

As our statement reflected, there are ingredients of the Japanese economy which create what we term a systemic problem. It reflects itself in the price competitiveness of Japanese equipment vis-a-vis U.S. products. But we cannot say that there has been or is a conspiracy to keep the yen/dollar relationship at its present level.

Mr. PEASE. Does that mean that you do not believe there is a conspiracy on the part of the Japanese?

Mr. ELDER. I would have to say that we don't have the basis for making that accusation.

Mr. PEASE. Good.

Mr. PETERSON. Congressman, on that particular subject, I don't know whether Dr. Bergsten would agree. I think in times past a reasonable question could be raised as to whether there was explicit intervention designed to keep the yen undervalued. My sense is that at the present time, partly for the reasons I mentioned to you, there is a widespread concern now in Japan about the possibility of protectionism in other parts of the world and about the fact that they have to pay enormous prices in dollars.

Just imagine the United States, to take an example, imagine you were importing 99½ percent of your oil, and you were paying for it in yen at 275 to the barrel, that $34, and you were saying to yourself, my God, I could be buying that oil at a third less than that in my own currency. Just imagine the kinds of pressures that would be building up, and just multiply that by all kinds of other situations.

I think there is a radically different situation, I would say, Fred, now than there was 5 years ago on this subject, and I do not know of any evidence that they are explicitly conspiring to keep the yen undervalued.

However, having said that, there still may be some aspects of the whole infrastructure of the capital markets, and the culture and the administrative guidance and so forth that in effect keeps the yen more undervalued than it would otherwise be. Now I wouldn't characterize that as a conspiracy.

A good deal of that may be historical, a good deal of it may be cultural, but the bottom line is that it helps keep the yen more undervalued than it would be if those restrictions were removed, and that is one of the reasons I would urge you to start focusing on some of those cultural historical transactions.

For example, I raised a question with the finance ministry without telling you the specific company. There is a policy over there that requires that companies that borrow money, for example, need to be approved, and they need to be approved by the finance ministry. So, I said to a member of the finance ministry who called on me after I pleaded for more open markets both ways, tell me why do you need to approve the registration of this great American company that is a multibillion dollar company, that has extraordinary growth records, superb balance sheet and so forth?

He explained very sincerely that they had to protect their investors.

I said, well, that is very interesting. In the United States we have a somewhat different view of that matter. We have disclosure statements that are put out by the Securities and Exchange, and there are criminal penalties for not disclosing everything essential. We then let the market assess the risks, and if the risks are a little higher for company A than company B, it costs them more money to borrow money than company B.

Don't you trust your investors to be equally intelligent?

Well, then, you get into a discussion of their culture and the relationship between government and business and so forth. I don't know that I would call that a conspiracy, Fred. I would call it the kind of a cultural, historical factor of a kind of an insular view of itself that needs to be protected from the rest of the world. Part of what I have been arguing with the Japanese is, you are certainly a senior partner in terms of share of world markets.

Why don't you start being a senior partner in foreign aid? Why don't you start being a senior partner in terms of currencies? Why don't you start being a senior partner in the terms of capital markets, because you are certainly benefiting from a global economy, and it is that type of thing rather than an explicit conspiracy?

I have no evidence of an explicit conspiracy on the yen.

Mr. BERGSTEN. I agree with that conclusion. I address the point on pages 8 to 10 of my statement, and did not cite them orally, just to save time.

I think it is understandable that your constituents might raise the question. It has been hard to explain why the yen has been so weak. We have tried to do it here, and we all have theories, but it does seem inconsistent with the underlying strength of their trade balance and current account, and so it is a bit hard to explain. That conjures up images of manipulation.

Second, they have done it in the past. I think I was the person, at least I take credit for doing it, of catching them redhanded in 1976 intervening very heavily, using hidden reserves in fact, to avoid strengthening of their currency, which market forces were pushing toward. They clearly were intervening to hold the yen down and maintain competitive advantage.

When we came into office in 1977 in the first week of our administration we said to them, at the highest level, get your hands off the exchange rate. Let it reflect market forces, and thereby strengthen it. To their credit, they did so.

The yen strengthened and after a lot of broken crockery in the meanwhile, the situation came much closer to equilibrium a year or two later after the normalization, so it has happened in the past.

I have looked very hard. I agree with Mr. Peterson's conclusion. Indeed, the Japanese have spent over $5 billion this year to keep the yen from weakening further. They have been intervening very heavily in the market, buying yen, selling dollars, running down their reserves, to keep the yen from weakening more, so if you look for any manipulation or conspiracy, you have to look to more indirect effects like the low interest rates that have been mentioned, like the capital liberalization, but that was urged on them by the United States and other governments around the world, so I would share the conclusion it is not manipulation. It is a big policy problem though, and as the Business Council has been saying, we have got to get on with dealing with it, not trying to assess blame or look for devil theories as to who is causing it.

Mr. PEASE. You suggested some reasons why the dollar is overvalued against the yen. Why is the dollar overvalued against most European currencies?

Mr. PETERSON. Again as a nontechnician, Congressman Pease, I tend to think a little bit more in terms of supply and demand, setting prices. You don't want to hear me make the speech more often about the grotesque fiscal deficits of the United States. But one of the terrible effects of those unbelievable deficits getting larger and larger and larger is, they attract, it would seem to me, Fred, foreign money who like getting these very high rates, and who, incidentally, have a very different tax system than we do, which is another subject of great importance, in which interest income is treated far more favorably than it is in this country. So when you can get a real interest return in the United States at the levels you can get it from government paper which, as you know, we can always print more money so they know they are going to get at least their dollars back. There is a worldwide demand for dollar denominated instruments that in a sense we have brought on ourselves by our very loose fiscal policies and our very tight monetary policies. So, our financially denominated instruments are very attractive and that has caused all kinds of money to come into the United States.

Mr. PEASE. That would be the chief reason?

Mr. PETERSON. To me it is certainly one of the principal reasons.

Let me put it another way, sir. I once said I would bet my reputation on something, and the other guy said, it will have to be something more substantial than that, but I would bet my reputation on this, for what it is worth.

If the Congress and the President of the United States tomorrow were to take some major steps that in the long term reduced the fiscal deficit in 1984, 1985, 1986, by tackling entitlements, by tackling defense, so that instead of seeing those huge deficits of $200 billion and more, they saw something in the range of 1½ percent heading toward balance, that in and of itself in my judgment would affect real interest rates long term significantly, and that in turn would affect the value of the dollar.

Mr. PEASE. I agree with you entirely, just for the record.

Chairman GIBBONS. Let me ask, why wouldn't that attract more dollars? Why wouldn't it attract more investment in America?

Mr. PETERSON. Well, one of the reasons, Mr. Chairman, is a lot of these people who have enormous amounts of money are making what I would call financially denominated investments of various types, and these huge hordes of money in the Mid-East and other places are looking at the rate of return they can get, Mr. Chairman, a piece of paper that is guaranteed by the U.S. printing press as it were, and they can get 11, 12, 13, 14 percent with inflation at 3, 4, or 5 percent, that is an awfully good return, and you "ain't got no risk" on that one, because you have liquidity. So, it is the high interest rates in turn have made it a great investment.

The safe haven theory is another one. With all of our problems, we are still a great country and the world's most important economy. Anybody making a financial investment in the United States of the type I mentioned isn't seriously worried that somehow our Government is going to go bankrupt, as it were, and that somehow we are not going to have a viable economy, so that they know that they can get paid back in dollars. It will be pretty good 5 or 10 years from now.

Chairman GIBBONS. Mainly, it is the that with very rapid liquidity that does it?

Mr. PETERSON. Well, it is the combination of that with very low risk. Again the University of Chicago people used to say to me, the kind of investment we all want to make in life is one with very high reward and zero risk. None of us, alas, ever achieve that objective, but we strive for it.

If you can get a very high real rate of interest, and you are going to get paid off in the currency of a very strong country, and you pay very little taxes on that interest income, that is an awfully attractive investment, Mr. Chairman.

Mr. PEASE. Mr. Chairman, do you want to intervene further?

Chairman GIBBONS. No, no.

Mr. PEASE. There was a time when the Federal Reserve, the Treasury, or both, I am not sure which, used to intervene in the capital markets to support the dollar. Are we in the intervention business now, and if we are not, should we be?

Mr. BERGSTEN. Maybe I should speak to that, since it was during my tenure that a lot of that was done.

You are quite right, that since the evolution of flexible exchange rates about 10 years ago, there have been alterations from time to time in U.S. policy toward intervening directly in the exchange markets. The most extensive efforts of that type were done from late 1978 through 1980 in support of the dollar. I mentioned before that episode, when the dollar came under such strong pressure, partly because the yen had been undervalued in 1976, and created huge imbalances. But when the $30 billion support package was put together in late 1978 and the Federal Reserve raised the discount rate by a full percentage point from 8 to 9—which was a big move at that time, the first time since the thirties they had moved the rate by a full percentage point in one fell swoop—we indicated our interest in putting our money where our mouth was, essentially to intervene both directly in the market with foreign currencies that we had and a willingness to go out and borrow foreign currencies in order to intervene further to support the dollar, if necessary, meaning we were confident we could repay those deutsch marks and Swiss francs at a better rate.

We were right. We made money on those transactions. The intervention in the markets both strengthened the dollar per se by affecting the supply/demand balance at the margin that I mentioned before, and gave confidence that the U.S. Government believed what it said. It wasn't just parroting a confidence that it could improve its economy and get its balance of payments in order. It was willing to put its money where its mouth was.

There is a very important lesson, though. One should not believe that he can turn the trend of exchange rates through intervention alone. At least I don't believe so. There is a debate on that point, but I don't believe you can turn the trend by intervention alone. However, if you are confident that the underlying trend is not being accurately reflected in the market, and particularly if you can convince the market that some steps you are taking will reverse that trend, then your direct intervention I think the record shows can substantially affect both the pace and the extent of the exchange rate move.

In late 1978, we were convinced, and we turned out in retrospect of course to be completely right, the dollar was substantially undervalued. It had weakened too far. We had 8 months of very hard data when we moved in November that our trade and current account position had already been improved substantially.

From the first quarter of the year we had had steady improvements but the markets continued to focus on other events. There was negative psychology, lack of confidence, et cetera. We were confident that combining a policy of tightening of monetary policies and coming in with direct intervention we were moving with the market and would push it in the proper direction.

Now there were ups and downs over the next year or so, but we did succeed in stabilizing the market. Then finally, in the mid-1980s the dollar took off even before the outbreak of huge budget deficits that Mr. Peterson mentioned.

Chairman GIBBONS. You succeeded too well.

Mr. BERGSTEN. When we left we had just the right level and then, given the budget deficits, it went out of control. Put that in the record.

You ask about right now. There is almost no direct exchange intervention right now. The current administration, I know you have them before you, have taken the view that intervention in the exchange markets is improper, that exchange rates should be left free to go wherever the market pushes them, and that even if you had a different view, you would be incapable of changing the situation through intervention policies.

I simply think they are wrong on both counts, but that has been the position. It has moderated perhaps a little bit over the last few months, but it is still basically a substance of nonintervention, and that I think has added at least to the degree of dollar overvaluation and improper alinement among the currencies that we are now paying such a price for.

Mr. **Pease**. If I can sneak in one last question, you have concentrated today in your testimony on exchange rate problems, undervaluation of the yen, and so on.

We are not the Banking Committee; we are the Trade Committee. Do you have any suggestions that would fall within the jurisdiction of this subcommittee?

Chairman **Gibbons**. While he is thinking about that, let me say we are talking about trade in currencies. That is our area.

We have the remedial tools. We could reimpose—and frankly I have to say I am giving it serious consideration—some kind of surcharge until we get this thing straightened out.

I agree the problem now is in the Japanese lap. They have to solve their problem, their undervalued yen, not us.

We can't solve the problem of their undervalued yen.

Mr. **Peterson**. Mr. Chairman, on the subject of what is trade and what is monetary, that is not the distinction I can even make.

I will remind you in 1971 when the import surcharge was imposed—I think, Fred, my recollection of history is accurate—there were certain provisions in the GATT that talked about a balance of payments emergency.

Chairman **Gibbons**. There certainly are.

Mr. **Peterson**. It was heavily stimulated by the trade deficit.

You are going to hear testimony from Mr. Fox, I believe, in a moment. When he and I were working in the Commerce Department, I think I recall his mentioning certain provisions that he might mention today even in the IMF that talks about various kinds of advantages, unfair and otherwise, that flow to trade from other factors.

So I think the distinction as to what is exchange rate and what is trade would be a very tough one for me to defend.

Mr. **Bergsten**. Mr. Chairman, if I might amplify, you referred earlier to the GATT ministerial meeting that just took place. I think we were all disappointed in the outcome of that meeting, but there was one modest ray of light in the communique where the GATT ministers meeting last week requested the Director General to consult the Managing Director of the International Monetary Fund on the possibility of a study of the effects of erratic fluctuations in exchange rates on international trade, report to the GATT Council, and to forward any such studies so it may consider implications for the GATT.

That is a weak version, but it does say they recognize in the GATT the relationship between trade and money; and at least they took an initial step toward seeing we get better coordination of these issues.

Chairman **Gibbons**. Let me disclose what I discussed with the staff yesterday. I intend to ask Mr. Volcker to come here to talk about this matter. I intend to invite, very strongly, the International Monetary Fund Director to come before this committee and discuss this problem.

I think it is a serious problem that cannot be any longer disregarded. So I expect to be extremely vigorous in pursuing this matter.

I am glad the gentleman from Ohio raised the question of jurisdiction. This is clearly within the jurisdiction of the Ways and Means Committee.

All of the remedies lie within our grasp. It is something that has to be done. We can't go along skirting this issue any further.

Mr. **Bergsten**. There is, in fact, a provision of the 1974 Trade Act in which you authorized the Tokyo round negotiations that made an explicit linkage between trade and money, talked about an import surcharge, but clearly indicated the relationship of monetary developments to trade policy and certainly is an indicator that exactly what you say can be done and in fact has been done in the past.

Mr. **Pease**. Mr. Chairman, thank you very much.

Chairman **Gibbons**. Excuse me for interrupting there. I thought you raised a very good point.

Mr. Schulze.

Mr. **Schulze**. Thank you, Mr. Chairman.

I thank you three gentlemen for a very cogent presentation.

I would much rather this hearing be held in the Japanese Diet and that they were concerned about the undervaluation of the dollar and the unfair advantage we had over their trade and that they would complain about the systemic problems in our economy which give us a great advantage in international trade.

I don't think one has to be Machiavellian to think perhaps that we have fumbled the ball somewhere along the route and that there are things which we could have and should have been doing over the years in order to have us in a more favorable position.

I agree with you gentlemen, this is one of the most important aspects of our trade policy and our trade imbalance.

Since it is a MEGO topic, I wonder if there has been any attempt to simplify it by putting all of these factors either into a computer or onto graphs or charts?

I have tried to find, and been unable to, this wide variety of factors which impacts on both the stability of the dollar versus other currencies as well as trade imbalances and all of the other factors.

I wonder if you gentlemen are aware of anyone who has done that or—so that we could, in effect, see graphically which factors are dominant and how they influence this relative stability or instability?

Mr. **Peterson**. Congressman Schulze, let me take a crack at the first part and part of the second part.

You might ask yourself an interesting question: If our unit labor costs since the days I was talking about, pre-1970's and post-1970's, had grown as little as the Japanese had grown, we would have had a different kind of problem, I suspect, than the one we have now.

I think a fundamental question to ask is why are their unit labor costs growing less than ours, which in turn gets you to why is their productivity so much higher than ours, and in the material I have left with you there is an article in there that you might want to scan that points out that during the decade of the 1970's they invested nearly 10 percent net of their GNP in plant and equipment versus our 3.4 percent.

There is a lot of talk these days about public infrastructure. They invested 5 percent of their GNP during the 1970's in public infrastructure; we invested 0.7. They invested 20 percent more than we did in private science and R&D, and in the elementary and high school levels they are investing a lot more in science education than we are.

I think part of the kind of analysis you are talking about ought to get to the real fundamentals, which is why is their productivity so much higher and why is the real income of their people growing so much faster than ours, which gets at part of the fundamental.

A closely related fundamental today to that, and which is why I keep harping on the fiscal deficit, we are now at the point with 5.5 percent of the GNP going into Government deficits, where we will be alone in the world, in that the entire household savings of our people will be taken to finance the Government deficit.

A lot of the so-called experts say to me, Mr. Peterson, you can't prove that high Government deficits affect interest rates directly; you can't prove that high deficits affect inflation directly; and I say I don't have to be an economist to understand that if you have a very shallow pool that we ought to refer to as a puddle of savings and Government deficits are negative savings, you are draining the very resource you need to invest more; so part of the fundamental problem that leads to these differential rates and unit labor costs is the fact we haven't been investing very much in our economic future, sir.

Mr. SCHULZE. Fred, do you know of any charts that have been——

Mr. BERGSTEN. Yes. There are lots and lots of charts. I think there are some—and I will send you a set—that compare the kinds of elements Mr. Peterson was mentioning, different rates of productivity growth, different rates of inflation, and how those then net out on to the currencies.

Mr. PETERSON. I think, Fred, I might add one of the charts I will send you showed the changes in exchange rates and compares that to the changes in unit labor costs. That is what I referred to in my testimony.

What this will tell you is there is something else very important going on besides changes in unit labor costs of our products because there is a very poor correlation between those two factors which would be the case in a perfect world in which exchange rates on the trade side followed unit labor costs.

I think you will see such factors as real interest rates and money flows have an enormous amount to do with exchange rates.

Mr. SCHULZE. That is why I asked the question.

It seems to me it should be obvious if you did that. I have been trying to get my own personal computer for the last 2 years. I would love to have one now to be able to put this myriad of factors into it and see.

I would have to assume it would paint a very graphic picture and tell us what we have to do and what the direction is we have to go.

Mr. **Peterson**. Forgive the plug, but that is why I am glad to be chairman of the Institute for International Economics.

It struck me as very strange that the No. 1 economy in the world did not have an institute focused on international economic issues.

Indeed, a man I respected a great deal, Mr. Chairman, when I was in Government, Chairman Mills, used to speak rather admiringly of the fact, you will recall, that he hadn't been to Europe.

There has been a kind of tradition in our public bodies of not only treating international economics as a MEGO subject but not really putting the research into this subject we put into a lot of other aspects.

The International Institute will be delighted to give you charts on that.

Mr. **Schulze**. What would be the effect of straight unilateral devaluation by the United States of the currency?

Mr. **Bergsten**. The first question is, how you would actually do it? We now do not peg our exchange rate to anything. Not to a gold price, not to a basket of currencies, not to anything.

So, even if the United States were to announce that it was its intention to change the dollar/yen rate from 250 to 1 to 200 to 1, that would not automatically happen.

Back on the fixed exchange rates it did automatically happen because you began then to defend, through exchange market intervention that Mr. Pease asked about, a new exchange rate around a very narrow band.

What you would have to do now, technically, is actually drive the rate through intervention and presumably policy measures from one level to another level.

As Mr. Peterson said, I think you could help that a great deal if you indicated that you viewed another rate as appropriate.

That would be particularly the case if the Government on the other end of the deal—in this case Japan—indicated it agreed. If the two took views that different relationships were appropriate, that, of course, would only add to the confusion.

If the two Governments responsible for those currencies indicated their view that the rate ought to be at some different level, that would certainly have a powerful impact.

It would not, however, be sufficient because the market still might doubt that the underlying economics were going to take it there or that the Governments would put enough money where their mouths were to actually sustain it at that level; and so you would have to do more than just make a statement.

So it is a modification under flexible rates of what was done in the old days.

You don't devalue or revalue per se, but, as I indicated before, there is a package of measures you could put together cooperatively with the other country that could sure move you a long way in that direction.

Mr. **Schulze**. We have to vote, so let me ask one more question. I have many more.

There is a lot of pressure in the Congress to force the Fed to lower the interest rates. What would be the effect of that kind of action?

Mr. **Peterson**. Congressman Schulze, I think we either have a catch 22 or a catch 44 operating here. I don't know which it is. That makes it two catch 22's.

In my judgment the horrible dilemma this country faces right now is, it has had an extraordinarily loose fiscal policy as evidenced by unprecedented deficits and all of the burden or most of the burden on fighting inflation has been ascribed to monetary policy.

That, of course, has forced interest rates very high.

Now, the reason I keep saying that you cannot run away from the need to tighten fiscal policy is if you envision the alternative, which is to simply loosen monetary policy so that you have both a loose monetary policy and a loose fiscal policy, then the financial markets are going to say, to use the President's expression, "Here we go again."

So the absolute fundamental that is required is to get our fiscal situation in order.

Now, if you took the very tough fiscal steps that were required, in that context, Fred, (a) you would need less money; but (b) you would be more able to be accommodating on the money side.

For Mr. Volcker to unilaterally go too far on the monetary side with no signals that we are really coming to grips with these huge spending programs would simply send a signal that we have given up on the fight on inflation and rates would go up again.

I call that catch 44.

Mr. **Schulze**. Thank you, gentlemen.

Thank you, Mr. Chairman.

Chairman **Gibbons**. Let me make an administrative announcement here for the benefit of the committee members and for the other witnesses.

The Chair plans to continue on with this panel until all members have had an adequate opportunity to discuss the matter with them and then to recess and come back at 2 p.m., at which time we will have another panel composed of the remaining three private sector witnesses. After that, we will hear from the administration.

I realize many of the administration are over in Europe now because of an international monetary meeting, but we are going to hear from them anyway.

This is not the last of the hearings on this subject. We are going to go into it deeply in this extended session of Congress. I want the world to know that this chairman is thinking about some very strong steps, not only on the side that you have talked about here, on U.S. fiscal policy, but on U.S. international policy.

I think we are in a terrible dilemma right now that we have to move in order to get our currency properly realined; and I intend to dredge every bit of every shred of evidence that we can from all of the international agencies as to what can be done and what should be done.

So, Mr. Bailey, this is just quorum call. I am willing to miss it if you are. Let's go right ahead.

Mr. **Bailey**. Thank you, Mr. Chairman.

I want to compliment the witnesses. They are some of the best to get at the roots of the problem. It is some of the best testimony we have had before the committee. I want to thank you for it.

Mr. Peterson, it might be considered an irony to many, but I do consider myself a friend of the Japanese too, which is why I wish very much that they would—and I have used some of the statements you have used here—grow up.

I wish they would do it quickly and listen very, very closely. I think they are riding for a fall and I don't think they realize how seriously.

Second, I think when you look at the exchange rate problems, you have got to do some of the things you just commented on a few seconds ago.

You have to go to the root causes.

Listening to Doug Fraser on a statement he made before the National Press Club, he said something that caught my ear.

He said, "You know, we used to refer in the country, a common press term, to knee-jerk liberals, and we learned some lessons."

Then he made a statement I agree with very, very strongly. He talked about knee-jerk free traders. That is a very simplistic term, but you can't look at systems in conflict and look at those exchange rates.

You all seem to be saying this.

Fred, I will go back to something you said before the committee one time, talking about Japanese weak currency policies to encourage a strong export economy that went back many, many, many years. You, Mr. Peterson, brought into the discussion here today the industrial policy. That is really what you were talking about.

You were talking about the role and function of government and the Japanese system.

You all started referring to issues like confidence, investor confidence.

It is easy to see why the yen is not any kind of world currency. That is simple. You have to read an average American newspaper, which doesn't tell you very much worthwhile about this issue, as you said, probably because it is too complex, and there's not much of a reader hunger for it.

But, if you look at what Japanese policy has been, I am not saying we are right either. We made a lot of mistakes too, particularly because we should have been providing more leadership a longer time ago.

It is easy to see why no one wants to speculate, invest in, or fool around in that market. There's not enough freedom there.

So you get down to solutions. I don't know what the solutions are.

I am not expertise enough in the short run. I am one of those people who really is quite cautious about making a quick, short-run change.

I do think, however, something of a comprehensive nature has been done. I had a brief discussion with Mr. Bergsten on this issue before. We have just got to learn to sit down and look comprehensively at respective national tax policies, the nexus of taxation uniformity of regulation and law, availability of court and law- -legal forums for contract enforcement in different countries.

We have to do all of those kinds of things.

What institutions are available to us?

I know the Congress is supposed to be an institution. Until we get rid of the knee-jerk free trade attitude in the country and start looking comprehensively at some of these policies, we will have the problem that the gentleman from Caterpillar has.

That is, when you go out and try to sell those excellent machines that you produce, you will be up against financing packages encouraged and controlled by a Japanese Government, for example, that makes it very difficult for you to do business.

I know what has happened to you in some cases. I am sure you do too.

How do we solve the problem?

Obviously there is no short-run currency interventionist policy available to us.

All of you seem to agree we have to get to the root problem. I think maybe if we showed some tendency to go after the root problem, maybe this investor confidence, this speculative confidence, would do something of a positive nature.

That is the only reason why, for example, I pride myself in supporting the domestic content law. I recognize and acknowledge it to be bad law. It is the only damned thing that brings about hearings like this, discussions of currency problems, and an awareness in the public of the nature of the problem. Sure it is lousy law. Sure it is not the right way to go. What is the alternative for making the Japanese listen though?

You have sat there and talked about their becoming aware. After repeated hits over the head with a sledge hammer, finally they are becoming aware.

Let me finish with this and ask your comments on how we could comprehensively approach the thing. One of the things that upset me, that didn't make big news in this country, was a little thing that occurred a few weeks ago on cigarettes, the selling of cigarettes in Japan.

Are you aware of that decision made by the Japanese Government, clear and total dishonest and overt violation—Mr. Frenzel on this committee is very aware personally—he was personally present when the discussions were entered into, on the marketing of American cigarette brands.

Maybe we shouldn't be selling cigarettes, but apparently the Japanese Government or policymakers gave in to colloquial political pressures which we, as politicians, would never understand, to try to discourage the sale of American cigarettes and the opening of that market.

It seems to fly in the face of everything we have been trying to accomplish.

What is the attitude there? What can be done in a comprehensive way to solve this problem? I have a tendency to think the Japanese just dribbled at it a little bit, make us happy, hope the problem goes away, and continue the strong export, low currency policies of 1976, not very long ago, really.

Has there been a big change since 1976? Are they frightened to do something?

Go ahead. Comment. Feel free.

Mr. **Peterson**. I have to leave in just a minute. I would like to pick up your word "comprehensive."

There is a subject we have not discussed which is immensely important which brings into this discussion what would well be one of the best things that has happened to the administration, in my view, or to the country in a long time, and that is George Schultz.

We haven't talked, Congressman Bailey, about a half trillion dollars of Third World debt, of $50 to $75 billion worth of debt service payments, of a group of countries whose exports are only $200 or $300 million.

Mr. **Bailey**. And they are being encouraged to borrow more.

Mr. **Peterson**. Precisely. At some point it does not take a banker or economist to understand the global economy has to start growing before they can possibly handle that debt service.

You can't have every major country in the world in a posture of fiscal restraint and somehow say the total is going to be a lot more than the sum of the parts or going in a growth direction while everybody is shrinking.

So one of the things we need of a comprehensive nature in my judgment, and friends' judgment, is to evolve some program together whereby we stimulate the world economy.

This is going to require the United States to play its full role, which I happen to believe is a fiscal role, but I think if we took that action, you might be able to encourage the Japanese for them to take some kind of role.

Mr. **Bailey**. Would you integrate Japanese industrial policy within the context of this discussion now, your view of it, its impact and effects?

Mr. **Peterson**. I am not going to give you the answer that you want, I am sorry.

Mr. **Bailey**. I am not interested in the answer I want.

Mr. **Peterson**. I will give you an honest answer to your question. You are hearing a lot of what I call razzle-dazzle proposals in America for how we ought to start national planning and picking industries.

Mr. **Bailey**. No, I don't believe that.

Mr. **Peterson**. What I would like to see us do is get our fiscal house in order, have a tax policy that strongly encourages savings and investment, supports research and development in a way in this country and start doing some of the fundamentals, which we have never tried, incidentally. We are like a football team with a bunch of players that have never been brought up on the fundamentals.

Mr. **Bailey**. Do you believe the Tax Code should play a role in that?

Mr. **Peterson**. All you have to do is compare how an investment appears to a Japanese person on interest and savings and dividends and compare it to this country.

Mr. **Bailey**. I would like very much to see that.

Mr. **Peterson**. I will send it to you. It makes an immense difference. We keep trying to explain the Japanese experience in some metaphysical cultural way, as if they are a culturally superior, bionic race. There are a lot of bottom-line reasons why those people do what they do over there.

A lot of it is in the tax system of the two countries, a lot of it.

Mr. **Bailey**. I couldn't agree more. I certainly like this answer the more I hear of it.

What changes would you recommend if you have 30 more seconds on their industrial policy? Do you think it affects the world view of them in the capital markets?

Mr. **Peterson**. You mean their industrial policies?

Mr. **Bailey**. Yes. Would you make recommendations if they were asked for?

Mr. **Peterson**. I have suggested some of them. I think in the capital area I would suggest to them, if for no other reason than the fact that accusations are endlessly made that they manipulate their currencies by all their capital controls, that they ought to adopt a policy of becoming a senior partner in the global financial markets.

That is an industrial policy, incidentally, of Japan.

A second one I would urge on them is that it is going to be very difficult to insulate their domestic economy from world flows of capital for domestic purposes, but then say that I want to share in the growth of the global economy and it is time they took the position that the United States took after the Second World War, namely, the world economy must be built and the leaders must step up and take the responsibility for it.

I think Secretary Schultz, incidentally, is likely to stimulate that kind of thinking.

Mr. **Bailey**. I think that is a beautiful answer. That is what I have been saying here for over a year. I am grateful to you.

Mr. **Peterson**. Thank you.

Mr. Chairman, I am going to miss that plane and a board meeting.

Chairman **Gibbons**. We don't want you to do that. We want to thank you and the other members of the panel for coming.

Mr. **Bailey**. Fred was going to comment, Mr. Chairman.

Chairman **Gibbons**. Let's excuse Mr. Peterson. It makes me sad the U.S. Government can't afford your brains.

Mr. **Bergsten**. We discussed this a bit during the last hearing. Obviously there are a wide range of aspects one could go into.

Certainly the numbers Mr. Peterson mentioned about the sharp disparity between United States and Japanese investment levels must underlie much of the problem that we face.

There are obvious things to do, like increasing Government support for private research and development activities, both through direct financial support and through provisions more attractive tax treatment for efforts of that type by the private sector.

One thing should be noted, though, and that is that productivity growth in all major countries—not just the United States—has declined very sharply over the last 10 years.

In fact, Japanese productivity growth has declined more than U.S. productivity growth since 1973.

Now, it is still at a higher level than ours—which is simply to suggest in addition—in addition to what we must do on a purely national basis, there are clearly worldwide phenomena out there that have pushed everybody's productivity, therefore economic growth, down; therefore, levels of unemployment up; which gets back to the point we made in the other context of the need to work internationally to promote a lot of the economic recovery that no country now, even our own, can probably pull off by itself.

Chairman GIBBONS. Of course, a lot of it is a result of that great commodity agreement known as OPEC.

Mr. BAILEY. I wanted to ask one question too. In connection with the long-term effect of capital outflows and investment patterns, how do you view that thing in the long-run context? Is that a detriment?

You talked about capital flows out of Japan; as a result of a strong dollar, investments here, and as opposed to just financial transactions, is there an effect that finds itself favorably encouraging investment in plant and equipment in this country as a result of these currency relationships?

If that is so—and I assume the answer is yes—what is the long-term effect? Is that something that is considered harmful to Japan? Beneficial to us? How much value does it have?

Can you give it some kind of relative meaning?

Mr. BERGSTEN. In past periods of dollar overvaluation in the currency markets, one clear result was an inducement to American firms to invest abroad rather than in the United States.

There were two reasons for that: When the dollar was overvalued in the currency markets, it became much cheaper to buy the German marks, the pounds sterling, whatever, to buy up foreign companies, or to build new plant and equipment there.

Second, when the dollar was overvalued, it was much more competitive to sell out of a foreign subsidiary rather than out of your U.S. home base, so in the 1960's, for example, when there was a very sustained period of growing dollar overvaluation, the trend toward foreign investment by American firms, which had already begun for a lot of other reasons, was intensified by the currency misalinement.

That was one reason that so much direct investment flowed into Western Europe.

Chairman GIBBONS. But that wasn't a market decision. That was a governmental decision.

Mr. BERGSTEN. It was a governmental decision to keep exchange rates fixed which perpetrated the overvaluation and created the problem Mr. Peterson referred to earlier.

But one result was a growing amount of foreign rather than domestic investment.

Since we have moved to flexible exchange rates, there has been a widespread perception—not always carried out in practice—but a widespread perception that exchange rate imbalances would not persist for too long; and, therefore, one should not invest abroad purely——

Mr. BAILEY. That is why I am asking what the long-term effect is.

Mr. BERGSTEN. It is tough to say that right now. As I indicated, there has been a perception that under flexible rates, big currency misalinements would not persist, at least for very long, so it would be a mistake to make longrun investment plans on the basis of currency imbalances.

That view may be shaken a bit by the events of the last couple of years where we have had this persistent and sizable dollar overvaluation.

I have picked up a few cases whereby over the last year or so firms have sourced a third country sale out of their foreign subsidiary rather than their U.S. subsidiary.

Mr. **Bailey**. But you don't see any significant increase in investor decisions because there is no confidence factor there?

The expectation is there will be a realinement?

Mr. **Bergsten**. You might ask Mr. Elder about that from the corporate sector. That is my judgment.

The bottom line has been over the last 4 or 5 years, an enormous flow of investment capital into the United States from the rest of the world. There have been two things that actually happened.

The share of investment by U.S. firms going to domestic rather than foreign investment has increased sharply since about the mid-1970's and there has, of course, been an enormous growth, 30 percent a year growth now for 5 or 6 years for foreign direct investment into the United States.

Mr. **Bailey**. You don't necessarily attribute that to the currency issue?

Mr. **Bergsten**. I attribute some of the start of that trend to currency, absolutely. Because, when the last big overvaluation of the dollar was ended about 1973 or 1974, that was the time at which the big foreign influx of direct investment here began to occur.

I think it was motivated primarily by other reasons, but the fact that the dollar was no longer overvalued meant that there was no longer a disincentive to invest here because of a price uncompetitiveness that had resulted in the earlier period from the exchange rate misalinement.

So that was an enabling factor in permitting foreign investment to come into the United States and create jobs and more productive plant here.

Mr. **Bailey**. Given productivity as an issue, though, you stopped very, very, very far short of calling a persistent currency difficulty vis-a-vis Japan any kind of blessing in disguise.

Given the current arguments you hear about capital shortfalls and investment difficulty—investment attractiveness——

Mr. **Bergsten**. No. I think in a situation where capacity utilization is at 68 percent and labor unemployment is 10.5 percent, the notion of capital shortage is really not very relevant.

Mr. **Bailey**. I agree.

I don't have any more questions, Mr. Chairman. Thank you.

Chairman **Gibbons**. I want to thank all of you gentlemen for your coming this morning and for your contribution. All of your statements will be included in the record in their entirety.

The committee will reconvene at 2 p.m.

[Whereupon, at 12:35 p.m., the subcommittee was recessed, to reconvene at 2 p.m., the same day.]

AFTERNOON SESSION

Chairman GIBBONS. The subcommittee will resume. We have this afternoon a panel consisting of Mr. Thomas P. McGrann, Mr. Lawrence A. Fox, and Mr. Ronald L. Danielian. Gentlemen, we will have Mr. McGrann proceed first. I apologize to you for keeping all of you so long this morning, but as you can see, the committee has a lot to learn about this subject, and we need your help. Go right ahead, sir.

STATEMENT OF THOMAS P. McGRANN, VICE PRESIDENT-COMMERCIAL, CF&I STEEL CORP., PUEBLO, COLO.

Mr. McGRANN. Mr. Chairman, thank you. My name is Thomas P. McGrann and I am vice president-commercial of CF&I Steel Corp. in Pueblo, Colo. I appreciate the opportunity to appear before you and your subcommittee this afternoon. What I would like to do is very briefly summarize my written statement which you have a copy of.

Chairman GIBBONS. Yes, sir, go right ahead.

Mr. McGRANN. CF&I Steel Corp. is a fully integrated steel company located in Colorado. We are about the 13th or 14th largest producer in the country, although we are the largest integrated steel producer west of the Mississippi River. We are a company that has been successful over the 100-year history of our company.

We have three basic product lines, Mr. Chairman, heavy T rails, which are used by the railroad industry in mainline track, wire products, which are used by the agribusiness community, and oil country tubular goods used by the oil industry in the drilling of oil and gas wells, and it is that product line, Mr. Chairman, that I would like to make a few comments on.

I must admit to you that I feel slightly in awe sitting at this table and at this microphone following such a learned and considered witnesses that you had this morning, discussing an issue that is very important to this subcommittee and very important to the Nation, as well as very important to our company.

I present CF&I's testimony not as an expert on foreign trade nor necessarily an expert on exchange rate issues, but I would like to ask you, if you would, to step with me a bit into the trenches, and that is I come to you today as a man who is responsible for selling steel mill products into a domestic tubular market which is international in nature.

CF&I Steel Co. has accepted this challenge to operate and to sell into this market. We have completed over the years very vigorously and very successfully, but my appearance today is to point out to you a circumstance which precludes the possibility of successful vigorous competition as a result of activities which we would consider to be unusual, and of a very, very peculiar nature.

In the spring of this year, as the oil and gas industry cut back on drilling programs, the marketplace for oil country tubular goods literally disappeared. CF&I as well as our major competitors in the oil country tubular business cut back our production from 100 percent of capacity in March of this year to a complete shutdown in June and July. We have operated our tubular mill only 2 or 3 weeks since June or July of this year.

Our European and Third World competitors in the marketplace also throttled back their shipments into this country, unlike our Japanese competitors, who for some reason have increased shipments, increased market share, and it is that issue which we want to call to your attention today.

In 1981 the Japanese had a 17-percent market share in the oil country tubular goods business in this country. By the third quarter of this year, their market share had gone to 50 percent, and in August of this year the Japanese had a 63-percent market share.

In other words, Mr. Chairman, as we were shutting our mills down, they were increasing their market share, and their shipments were nearly the same in the third quarter as they were in the second. Their shipments in the second quarter were greater than they were in the first.

Our initial reaction was to assume that the Japanese were selling on a long-term contractual basis, so we went to the marketplace to talk to our customers to ask them why they continued to import Japanese pipe at the same time they were canceling orders with European Third World and U.S. domestic producers.

What we found was a rather unusual situation. We were told by both major oil companies and by oil country goods distributors that the Japanese were bringing pipe in and maintaining ownership at the trading company level. They were also bringing pipe in and selling it on consignment to distributors, and telling the distributors that after a year if the pipe was not actually sold to an end user, that the trading companies would take the pipe back.

Our question was how can they do this and why would they do this. The why is probably fairly simple.

The Japanese, like CF&I, and like most of our domestic competitors, feel that the oil country goods tubular market will come back. As drilling programs stabilize and as the need for further drilling in the continental United States increases, this market will be in the long term a very strong market.

Obviously the Japanese share this view, and have built up this inventory in an anticipation of a return of this market sometime in 1983.

The how is more complicated. How can a country, how can companies bring into a nonexistent market an inventory, and in our view this inventory held by Japanese trading companies and by distributors on consignment may approach $1 billion. How do you finance that inventory for 6, 9, or 12 months waiting for a market to return?

There is another possibility that we have considered, although certainly this is just speculation on our part. That would be the strategy on the part of the Japanese to build an inventory during a period of currency weakness, hold that inventory, and sell it in a period of relative currency strength. It is to that issue that I would direct your attention.

The importance of this to CF&I is that it is our view the Japanese will sell this inventory as the market improves below our costs. If there should be a strengthening of the yen, they could hold the price, receive more yen, improve their profitability by having this inventory in place. It also threatens the very basic viability of our company. That is without an oil country market to operate in, CF&I Steel would lose 30 percent of its revenues, so we are talking about basic viability in our company's interests and our employees' interests.

Right now our total steel mill operation is operating at 40 percent of capacity. Our normal complement of 6,000 employees has been cut back to 3,000. We live and work in a community of about 100,000 people in Pueblo, Colo. The unemployment rate in Pueblo County is near 12 percent. One half of the unemployed people in Pueblo County are CF&I employees.

We have come here today to say that the current trade laws do not cover the ability of a foreign country to create an artificial market, whether it be by interest rate subsidization on the part of the Japanese Government, or whether it is because of fluctuating exchange rates, we are not sure.

We are still investigating how best to protect our company, and we implore the subcommittee to review our current trade laws to determine the appropriate ways in which they might be revised, so as to give us the means to defend ourselves against the kind of artificial and injurious market practice which we believe the Japanese are now engaging in.

Thank you for your attention, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF THOMAS P. MCGRANN, VICE PRESIDENT—COMMERCIAL, CF & I STEEL CORP., PUEBLO, COLO.

My name is Thomas P. McGrann and I am Vice President-Commercial of CF&I Steel Corporation in Pueblo, Colorado. CF&I Steel Corporation is a fully integrated steel producer whose products include heavy "T" rails used by railroads for mainline track, wire products used in manufacturing and agri-business and oil country tubular goods used by the oil industry in the drilling and completion of oil and gas wells.

CF&I's overall steel business is operating today at 40 percent of capacity. Our oil country tubular business, however, is nearly non-existent due to an elimination of demand for newly produced pipe as a result of a downturn in drilling activity and an excess pipe inventory accumulation. CF&I stopped manufacturing oil country tubular goods in July, 1982 and has reopened the mill for only a brief two-week period since that time. CF&I's major U.S. competitors, ARMCO, U.S. Steel, Republic, Jones & Laughlin, Wheeling-Pittsburgh, National and Lone Star Steel, also stopped manufacturing oil country tubular goods at about the same time and have operated only sporadically since. Our European and Third World competitors have followed the same pattern of reducing shipments to this country to more nearly match demand

Despite the fact that U.S. tubular goods manufacturing has nearly stopped, a year and one-half supply (5 million tons) of oil country tubular goods has continued to grow all summer and fall. The explanation for this rise is the continued growth of imports from Japan. In the first quarter of 1982, imports of Japanese oil company tubular goods were 363,000 tons, a 19 percent market share. In the second quarter, with domestic mill shipments down 62 percent from the previous quarter, Japanese imports actually increased to 369,000 tons, a 33 percent market share. In the third quarter, with domestic mill shipments down 87 percent from the first quarter, Japanese imports were 229,000 tons, an astounding 50 percent market share! In August, Japanese imports increased to a 63 percent market share, while U.S. shipments dropped to 32,000 tons in August 1982 from 340,000 tons in August of last year.

Shipments of oil country tubular goods from foreign countries other than Japan, by contrast, have declined throughout 1982 in parallel with U.S. domestic mill shipments, and have shown virtually no increase in market share throughout 1982. Therefore, the continued rise in tubular inventories, during 1982 at least, consisted exclusively of Japanese tubular products. Although the distributors of this inventory of Japanese goods have reportedly offered it at half the U.S. domestic price, they have had few buyers.

This tremendous inventory overhang being held by distributors and trading companies will be dumped on the consuming market at distressed prices as the oil and gas drilling pace recovers. We are deeply concerned that when the consuming market recovers, we will not be able to participate and put our employees back to work because the Japanese will want to move this inventory, and will do so at prices below our cost.

You must be wondering, as we have, how the Japanese steel mills and trading companies have managed to engineer this huge inventory buildup during a time of an unprecedented decrease in demand. We do not know the precise method, but I suggest that such a buildup could not have been accomplished without a substantial subsidy from somewhere. It would not surprise us if ultimately and indirectly the Japanese Government provided some form of subsidy for the heavy interest payment costs of maintaining such an inventory.

Aside from how this has occurred, there is also the question why. Once again, we do not claim to have the answer, but we would not be surprised if the answer related to the yendollar exchange rate. It is quite possible that in a year or so when the U.S. real demand revives, the yen will have appreciated to such a point as to reduce Japanese profits. But, by importing now at the depressed yen rate and storing the products in the U.S., the Japanese profits will be greater down the road when the demand revives.

Whatever the method or the motive, the result is that there has been created a totally artificial market at the distributor level in the United States for oil country tubular products. Without governmental influence or support, these continuing sales of Japanese tubular goods would not occur, this inventory overhang would not exist, and when the U.S. consumer market revives we would be able to compete fairly.

We are still investigating how best to protect ourselves. However, it may well be that our laws are inadequate to deal with this type of artifical market creation. Yet, the situation which faces our unemployed workers and our company is extremely painful today and for the foreseeable future. I therefore encourage you to review our trade laws to determine appropriate ways in which they might be revised so as to give us the means to defend ourselves so that this artificial and injurious marketing practice can be stopped.

Chairman GIBBONS. Thank you. You raise a lot of questions. I will be happy to try to expand on them.

Our next witness is Mr. Fox.

STATEMENT OF LAWRENCE A. FOX, VICE PRESIDENT FOR INTERNATIONAL ECONOMIC AFFAIRS, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. FOX. Thank you, Mr. Chairman. I have a statement for the record, and if you would make it a part of the record I would appreciate it.

Chairman GIBBONS. Yes, sir, all statements will be made a part of the record.

Mr. FOX. I will proceed to summarize my comments. I think the presentations this morning have fully and fairly covered the basic views that the National Association of Manufacturers has with respect to the yen/dollar exchange rate. I will try to do two things in the next few minutes: one, add a degree of historical perspective on that problem, and, second, to suggest a possible solution.

First, on the historical perspective, it is obvious to me—and I have observed the U.S. trade relations with Japan and the rest of the world since the end of 1945 in a professional way—that the Japanese have during that period basically pursued a policy of an undervalued yen, and they have done so for reasons of commercial and industrial policy.

An undervalued yen clearly makes their products more competitive in foreign markets, makes foreign products more expensive in their own market, and produces a certain allocation of resources in the direction of export industries.

Except for a few years in the 1970's, the yen has been undervalued for virtually the entire postwar period, and I would judge it to be seriously undervalued today.

There is no question in my mind that at this time the Japanese Government is not manipulating the exchange rate in the traditional usage of that word, although I find it amusing that people would ask that question as if the Japanese could be capable of manipulating anything including the exchange rate under these circumstances. I think, if anything, the Japanese Government would like to have the yen strengthened, but is incapable of doing so under present conditions.

The problem of the weak yen is a systemic problem. The world system, of which the United States is the center in the international monetary sense, tends to push up the value of the dollar. This is so, for the reasons that Mr. Peterson and others mentioned this morning, particularly the very heavy capital inflows for real interest rate reasons and safe haven reasons and many other good reasons.

The other aspect of the systemic problem is the situation in Japan where Japan has constructed a system that insulates Japan's economy, to a degree, from the world market. It particularly insulates its monetary system and its financial system from world markets. That has two principal advantages, or it has had two advantages from the Japanese point of view.

It has given Japanese monetary authorities substantial control over their economy, which has permitted them to moderate swings in the business cycle, and in the export-import balance. It has also permitted them gradually to establish a cheap money policy throughout the country, having the advantage of helping them pay off the debt.

Mr. Wright Patman, in this chamber, preferred cheap money to pay off the debt, and I think that view is held in Japan. But more particularly in Japan cheap money is an instrument of commercial policy, and the chosen industries have always found it possible to go to the bank and get money below market rate almost without regard to their balance sheet. That particular aspect of cheap money is particularly disturbing at this time in connection with the competitive situation in the United States, as explained this morning by the representatives of Caterpillar.

So we have a situation in which the yen is cheap for reasons that are systemic in the global sense of pushing the dollar up, and systemic in the Japanese sense of keeping the yen down.

How would one deal with that? I think it is important to regard the matter as not transitional to something better, although we know the yen has dropped a bit lately. I would, rather, address the world systemic situation first, and suggest how the yen/dollar exchange rate might fit into that.

The proposal I make is far from original with me. It is a system of target zones. You would have three reference points, I would say, sort of pulling it out of the air, but you could pull it out of the IMF computer. There is no 100-percent perfect way of getting these reference points, but you could say for the purpose of starting out 200 yen to the dollar, two deutschemarks to the dollar, 2.15 deutschemarks to the dollar, whatever.

The three governments would agree that they would maintain these reference points give or take 5 percentage points, or possibly 7½ percentage points on either side. That is a big variation from the reference point.

I would remind you that under Bretton Woods the variation allowed was three-quarters of a point, so I am saying this recognizes the current conditions of lots of money in the world available to speculate against currencies, and to slosh around, as Mr. Peterson said. But one should start off initially where the three governments would, with the cooperation of the IMF, announce that they are going to seek to limit the fluctuations in exchange rates within these starting zones, and they would take the necessary steps to accomplish that purpose.

Among those steps would be coordinated currency intervention, a narrowing of the interest rate gap between the United States and Japan, a coordination of budget and monetary policies in other respects, and other steps as required without specifying in advance what those might be.

It seems to me, based on the consultations we have had in the NAM, that the markets, the foreign exchange markets, would be quite willing to give the new system a chance to work. I don't think anybody, even the Sheik of Araby, with a half billion dollars, wants to speculate against the combined resources of the U.S. Treasury, its Federal Reserve, which, as Mr. Peterson pointed out, has a printing press, the Bank of Japan, the Treasury of Japan, the Bundes bank, the Bank and the Treasury of Germany, plus the resources of the IMF.

My feeling is that a firm announcement by governments that they would not permit the world trading system to be ravished by an irrational system of exchange rates would have a calming effect on the market. Furthermore, my opinion is that the introduction of a system of target zones could take place in a remarkably short time, effectively.

Since the Japanese budget year begins April 1, and since we have a new government in Japan, I would suggest that American authorities make proposals to Japan quietly, along with proposals to Germany in the same way, quite quickly. I believe the Japanese authorities would welcome the end of the tension over the exchange rate. If we moved quickly, I would think that this matter could be resolved in the month of January or February and that the new budget year beginning April 1 in Japan might reflect the new realities of the exchange rate.

Now, the approach I have outlined really represents the recognition of a discontinuity. Floating exchange rates, although they did their job under remarkably difficult circumstances, with the change in oil prices and other conditions, are now inadequate. To use an old saw, today's solution is tomorrow's problem.

Well, the problem today is that the rates are simply misalined. It is not that they vary too much. They are simply misalined, and a rate of the dollar to the yen, which by most calculations of purchasing power parity or any rational theory ought to be around 180 or possibly 200 or even 210, whatever you want, something in the range of 185 to 200, has recently been as high as 275.

Similarly, the deutschemark is undervalued, but not for similar reasons. Basically the markets are open in Europe, in Frankfurt, in London, and in New York. Circumstances are different in Europe. Mr. Peterson suggested that simply supply and demand for European currencies might be the most important factor.

I wouldn't attempt to state what the factor is, but I would state quite clearly that the problem in Germany is quite different from that in Japan. It is not a systemic problem as it is with respect to the insularity of the Japanese monetary and financial system.

The advantages of the proposal that I have made is the announcement of the discontinuity and the statement of the will of governments and the IMF to deal with this discontinuity in a constructive way and to facilitate the growth of world trade rather than to permit world trade to be ravished, as I have said, by these irrational exchange rates.

What are the chances that the proposal that I have suggested would work? I have already indicated I think the chances might be very good, but in this world there really is no certainty. Perhaps you approach certainty in one respect, with respect to trade that is, if we do nothing. If we do nothing, the current world trading system, which could be characterized as an open world trading system, or a semiopen world trading system, or, as I would characterize it, as a semiclosed world trading system, that system will deteriorate further while the exchange rate uncertainties bring into the very fore protectionist measures in all our countries, because of the serious economic circumstances and the serious unemployment that prevails in most of our countries, and prevails even to a limited extent in Japan by Japanese standards.

I would like to conclude with a serious observation with regard to domestic monetary policy. If the exchange rate issue is to be solved, the interest rate disparity between the United States and Japan must be reduced. While that interest rate disparity continues, all the factors that we have referred to this morning, the witnesses and yourself, Mr. Chairman, prevail.

The safest place to put money is in the United States. The safehaven effect applies as well as the normal application of risk aversion. That principle applies. I think the dollar will remain strong for a rather long while, because so long as Japan artifically induces low interest rates and the American domestic monetary policy, as well as the international conditions I have described tend to push up the dollar, the interest rate disparity makes the solution of the problem extremely difficult.

I would not be prepared to say that the targets of the system that I have outlined would work if we do nothing to close that interest rate disparity. I feel that the program I have outlined would be a good first step, preferable to the step of imposing an import surcharge, but I think it is appropriate to consider alternatives.

Japanese colleagues of mine, and I consider them friends, have sought different alternatives in Japan, including an export surcharge, which was discussed this morning by Mr. Peterson.

That is always an alternative, but it is jury rigging the system. It is dealing with a Band-Aid, or using a peculiarity to change a peculiar application of a special act, to change what is a fundamental imbalance and irrational situation in exchange rates. So, rather than o to Japanese export controls or export surcharges or U.S. import charges, I would proceed on the more constructive course, and if that course doesn't work, because either the Treasury Department of the United States refuses to take the initiative, or because other countries can't agree with us on appropriate exchange rates to subject to this new regime, then, of course, other alternatives should be considered.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF LAWRENCE A. FOX, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. Chairman, Members of the Subcommittee, I am Lawrence A. Fox, Vice President for International Economic Affairs for the National Association of Manufacturers. A few weeks ago I testified before this Subcommittee on behalf of NAM on the domestic content legislation, H.R. 5133. We testified that we considered that legislation misguided, and reviewed for the Subcommittee the salient aspects of our trade problems and some of the needed steps to improve U.S. trade performance.

You will recall that I said then that a major factor in our trade imbalance with Japan has been the gross misalignment of the yen and the dollar. I am, therefore, pleased that the Subcommittee has decided to hold hearings on this important subject and pleased to have been invited to testify. Let me now turn to the subject at hand—the undervalued yen and the consequences for U.S. trade. I would begin by making the following observations:

1. Whether the dollar is over-valued or the yen is undervalued is a semantic problem. Since both assertions are obviously in some measure correct, we should move directly to the exchange rate, namely the relationship of the two currencies.

2. We all know, of course, that an undervalued currency tends to promote exports by making goods cheaper in foreign markets. Correspondingly, imports are made more expensive in the importing country. It is a matter of little consequence as to what the intention of policy is, it is the result in the exchange rate that counts. Thus, if the U.S. Government has caused the value of the dollar to rise by its monetary or other policies and the Japanese government has caused or permitted the yen to fall by its economic policies, the results are the same in so far as the exchange rate is concerned. The result is to help sell Japanese goods in the U.S. market (because the price is cheap) and in third country markets in competition with U.S. goods because the Japanese goods are cheap and the U.S. goods are expensive. A second result is to make U.S. goods expensive in Japan because U.S. goods are higher in price. Obviously, the trade imbalance between our two countries is accentuated by a persisting condition of an undervalued yen.

3. The exchange rate today is 250 yen to the dollar, having been as low as 220 only a few months ago. You will recall that 18 or 19 months ago it was close to 200 to the dollar. That means that Japanese goods could be priced as much as one-third lower in the U.S. market for exchange rate reasons alone. Back when the yen was 200 to the dollar, many experts thought that it was not properly valued and suggested that 180 or 185 would have been more realistic.

4. The yen-dollar exchange rate should be viewed, however, in the perspective of 20 or 30 years, and not just in the time frame of a year or two. It is evident to most observers of U.S.-Japan trade relations that the yen has been undervalued for most of the time since the mid-1960's when the U.S.-Japan trade balance shifted from a positive to a negative, i.e., when the Japanese deficit changed to surplus in our bilateral merchandise trade balance. Personally, I believe Japan's post-war, basically mercantilistic trade-industrial policy has more or less been premised on an undervalued currency and to some extent still is. Except for a year to two or three in the 1970's as the Bretton Woods par value system came to an end on August 15, 1971, and floating was installed in March 1973, the yen has been undervalued relative to the dollar. From the Japanese point of view, the cheap yen is a wonderful way to move its industry up to high technology, high value added goods, i.e., away from textiles to 64-KRAM's. The undervalued yen results in Japanese underpricing the products of the new technologically based industries in the U.S. and world markets—while pricing competing American godds out of the Japanese market by means of the same undervalued yen.

5. At the present time and for the year 1982 as a whole, Japan has not been trying to depreciate the yen. Quite the opposite is true. Japanese authorities have been embarrassed by the weak yen and the inordinate trade advantage it has con-

ferred on Japanese goods. However, Japan's intervention in currency markets to strengthen the yen during the year has obviously been futile.

THE OVERVALUED DOLLAR

As I have indicated, the dollar appropriately may and probably should be viewed as overvalued. In trade terms, the dollar is undoubtedly over-valued—not just against the yen but against the D-mark. The dollar, being over-valued against the D-mark means, of course, that through the operation of the European Monetary System (The Snake), the dollar is over-valued against many or most currencies in the EMS. In any case, the dollar in trade terms helps to give German goods a price advantage over American goods in Germany, in third country markets, and in the U.S. market.

Why is the dollar over-valued? It is over-valued for a number of reasons, but most importantly because capital inflows in the United States have "swamped" the international monetary picture. Dollars are scarce and therefore their price is high—not because the United States is running an efficient industrial economy but because U.S. interest rates in both nominal and real terms have been at historically high levels. Also, a so-called safe haven effect has emerged in the minds of financial managers all over the world. The United States is really the only place for money managers charged with protecting the asset value of their clients' money to place large sums of money. That is one reason why we see the phenomenon of U.S. pension funds of the British miners' union invested in the purcahse of more than one office building in Washington, and why Canadian funds have sought investments in the United States—and why Japanese money has moved to New York following the elimination of certain capital and exchange controls by the Government of Japan.

If nothing is done, will the dollar remain over-valued and the yen undervalued? And if the answer is, "Yes", what are the consequences? turning to the second question first, as to the consequences of persistence of the present dollar-yen exchange rate: the results are entirely predictable. The U.S.-Japan trade imbalance will become even more severe, jobs will be lost in the United States because of excessive imports from Japan and other countries whose goods are too cheap because of the high value of the dollar, and jobs will be lost because American goods will be priced out of otherwise suitable export markets. Unfortunately, the results will also be seen in other terms, most probably a turn to protectionism in American commercial policy. A recent report of the Group of Thirty, made up of distinguished American and foreign experts in international finance writing as individuals rather than as officials of governments or international private and public institutions, made this statement, which I paraphrase: An overly strong currency maintained for an overly long period of time is a prescription for de-industrialization. Many might think the statement referred to the United Kingdom in the period since the end of World War II. I suggest the statement should be read to apply to the United States today.

If the United States is to overcome its present economic difficulties of no-growth, it should be reasonably evident that new investment is needed. Certainly, new investment is needed in the American industrial base. That is why business taxes were reduced and why business and labor, Democrats and Republicans, and just about every serious observer of the economic scene, is united in the view that new business investment is vital to a resumption of healthy, non-inflationary growth. The leaders of America's industrial establishment recently met with half the Cabinet and key White House officials to say plainly that something must be done regarding the yen-dollar exchange rate. New business investment in America's industrial heartland is not being held back by high interest rates alone. In the case of industries which must compete head-to-head with Japan in the U.S. home market and in foreign markets, the yen-dollar exchange rate is a deterrent to new business investment of commensurate magnitude to high interest rates. These hearings today, Mr. Chairman, serve as a responsible forum to examine this problem and to seek an appropriate and responsible solution.

I have answered the first question implicitly, i.e., if nothing is done, the dollar will remain strong, the yen will remain relatively weak, and we will be placing at risk the industrial future of the United States. Also, we may very well be laying the ground work for a return to world-wide protectionism.

A PROPOSED SOLUTION TO THE EXCHANGE RATE PROBLEM

It is an old saw that today's solution is tomorrow's problem. The par-value system of Bretton Woods became outdated and was replaced by a flexible system of managed floating. The system of managed floating is nominally supervised by the International Monetary Fund. Article IV of the Articles of Agreement of the Fund places on the IMF the responsibility to supervise the currency values of member countries in such a way that the floating exchange rate system is not abused. Member countries are enjoined to avoid manipulation of exchange rates, ". . . to gain an unfair competitive advantage over other members." Article IV, the so-called surveillance article regarding exchange rates among all member countries, requires that the IMF in meeting its responsibilities take into account, ". . . behaviour of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements." A copy of Article IV and guidelines for its implementation are attached to this statement.

I cite the IMF responsibilities not so much to indicate that somehow the Fund has not met its responsibilities but rather to express the view that today's problem—serious and gross misalignment of the yen-dollar-D-mark exchange rates threatens the very basis on which the world's trade and financial systems exist. I refer to Article IV and IMF responsibilities in exchange rate management to suggest the solution to the exchange rate problem as it affects the U.S. trade with Japan and world trade more generally. The U.S. Government is as responsible as any country for failing to make proper use of the IMF to help resolve the exchange rate dilemma. The solution I suggest is the following:

1. A three-point reference or target zone system: say, the yen at 200 to the dollar, the D-mark at 2.00 or 2.15 or 2.25 to the dollar. The reference points could and should be changed from time to time in cooperation with the Fund to reflect changes in fundamental economic conditions such as inflation and productivity

2. The U.S., Japan, and Germany, in cooperation with the International Monetary Fund, should state publicly their determination to establish these reference points and maintain the values of their currencies within five percentage points or 7.5 percentage points on either side of the reference points, thus creating agreed target zones. You will recall that orginally the par-value system under Bretton Woods called for a maximum of ¾ of one point on either side of the established par values.

3. The three governments, along with the IMF, should state in the most forceful terms possible their will to restore orderly and realistic conditions in the foreign exchange markets—and their determination to use all the means at their disposal to achieve their goal. And the goal must be stated to include maintaining an open world trading system. This system already shows great strain—and may probably more accurately be referred to as a semi-open (or semi-closed) world trading system.

4. The three governments in describing "all the means at their disposal" should make it abundantly clear that they include: intervention in foreign exchange markets, reduction in an interest rate disparities and other macroeconomic policies to achieve the intended result in the foreign exchange relationships among the three currencies.

Will this "target zone/reference point" system work? Well, there are no certainties in this world. There are only probabilities. I see one "certainty" more clearly then others, however. If we—the United States, Japan, and Germany—do nothing but accuse each other of failing to meet our economic responsibilities to each other and to the interdependent world economic system in which we live, then one probability will emerge as the clearest prospect for certainty: protectionism will be installed all over the world whether GATT continues or not, and whether the United States prefers free markets for goods, services, and capital.

I must state that one very important pre-condition exists to the success of the program I have outlined above. Its chances of working are vitally affected by or prehaps even determined by the narrowing of the interest rate gap that exists between Japan and the United States. By this I mean, U.S. interest rates must fall in nominal and real terms, and Japanese interest rates must rise. I will not attempt to prescribe for Japan how its part of the interest rate picture is to be met—but interest rates in an interdependent financial world market cannot continue with Japan's industry able to borrow captial at 6 or 7 percent while industry in the United States, Canada, and Western Europe must pay 5 to 10 percentage points more for capital. Japanese industry cannot continue to be given the present supervening advantage over the industries of the U.S. and European countries in the cost of capital to modernize plus the price advantage to exported goods conferred by a currency that is undervalued by as much as 25 to 35 percent.

I have not attempted to explain just how the Japanese authorities have insulated their financial markets from those of the rest of the world to produce the results I have described in terms of interest rates and exchange rates. That subject is obviously an important one that we all need to understand more fully. I have no doubt, however, that the present threat to the world-trading system posed by the supercompetitiveness of Japanese internationally traded goods is not a goal sought by

Japanese policy today. Nor do I believe that the failure of the U.S. Government to act effectively to help correct the exchange rate misalignment with the yen need go unnoticed.

I would conclude on a note of urgency. The GATT Ministerial has taken place and it is evident that the GATT-supervised system of world trade is under great strain. I think the solution of the exchange rate problem is of the greatest urgency in helping to relieve that strain. I think the proposed new system of target zones should be negotiated immediately and put into effect promptly. The new Japanese government will adopt its new budget on April 1, 1983. That budget should be based on the realities of exchange rates and interest rates that I have just outlined. This would be in Japan's interest, in the interest of the United States, and in the interest of the maintenance of an open world trading system.

[From Floating Exchange Rates and International Monetary Reform, by Thomas D. Willett]

APPENDIX.—ARTICLES OF AGREEMENT OF THE INTERNATIONAL MONETARY FUND

ARTICLE IV.—OBLIGATIONS REGARDING EXCHANGE ARRANGEMENTS

Section 1. General obligations of members

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

(i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and

(iv) follow exchange policies compatible with the undertakings under this Section.

Section 2. General exchange arrangements

(a) Each member shall notify the Fund, within thirty days after the date of the second amendment of this Agreement, of the exchange arrangements it intends to apply in fulfillment of its obligations under Section 1 of this Article, and shall notify the Fund promptly of any changes in its exchange arrangements.

(b) Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member's choice.

(c) To accord with the development of the international monetary system, the Fund, by an eighty-five percent majority of the total voting power, may make provision for general exchange arrangements without limiting the right of members to have exchange arrangements of their choice consistent with the purposes of the Fund and the obligations under Section 1 of this Article.

Section 3. Surveillance over exchange arrangements

(a) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.

(b) In order to fulfill its functions under (a) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.

Section 4. Par values

The Fund may determine, by an eighty-five percent majority of the total voting power, that international economic conditions permit the introduction of a widespread system of exchange arrangements based on stable but adjustable par values. The Fund shall make the determination on the basis of the underlying stability of the world economy, and for this purpose shall take into account price movements and rates of expansion in the economies of members. The determination shall be made in light of the evolution of the international monetary system, with particular reference to sources of liquidity, and, in order to ensure the effective operation of a system of par values, to arrangements under which both members in surplus and members in deficit in their balances of payments take prompt, effective, and symmetrical action to achieve adjustment, as well as to arrangements for intervention and the treatment of imbalances. Upon making such determination, the Fund shall notify members that the provisions of Schedule C apply.

Section 5. Separate currencies within a member's territories

(a) Action by a member with respect to its currency under this Article shall be deemed to apply to apply to the separate currencies of all territories in respect of which the member has accepted this Agreement under Article XXXI, Section 2(g) unless the member declares that its action relates either to the metropolitan currency alone, or only to one or more specified separate currencies, or to the metropolitan currency and one or more specified separate currencies.

(b) Action by the Fund under this Article shall be deemed to relate to all currencies of a member referred to in (a) above unless the Fund declares otherwise.

INTERNATIONAL MONETARY FUND EXECUTIVE BOARD DECISION ON SURVEILLANCE OVER EXCHANGE RATE POLICIES, APRIL 29, 1977

1. The Executive Board has discussed the implementation of Article IV of the proposed second amendment of the Articles of Agreement and has approved the attached document entitled Surveillance over Exchange Rate Policies. The Fund shall act in accordance with this document when the second amendment becomes effective. In the period before that date the Fund shall continue to conduct consultations in accordance with present procedures and decisions.

2. The Fund shall review the document entitled Surveillance over Exchange Rate Policies at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

GENERAL PRINCIPLES

Article IV, Section 3(a) provides that "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article." Article IV, Section 3(b) provides that in order to fulfill its functions under 3(a), "the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." Article IV, Section 3(b) also provides that "The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members." In addition, Article IV, Section 3(b) requires that "Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies."

The principles and procedures set out below, which apply to all members whatever their exchange arrangements and whatever their balance-of-payments position, are adopted by the Fund in order to perform its functions under Section 3(b). They are not necessarily comprehensive and are subject to reconsideration in the light of experience. They do not deal directly with the Fund's responsibilities referred to in Section 3(a), although it is recognized that there is a close relationship between domestic and international economic policies. This relationship is emphasized in Article IV which includes the following provision: Recognizing ... that a principal objective (of the international monetary system) is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates."

PRINCIPLES FOR THE GUIDANCE OF MEMBERS' EXCHANGE RATE POLICIES

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions which may be characterized inter alia by disruptive short-term movements in the exchange value of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

PRINCIPLES OF FUND SURVEILLANCE OVER EXCHANGE RATE POLICIES

1. The surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop. The functioning of the international adjustment process shall be kept under review by the Executive Board and Interim Committee and the assessment of its operation shall be taken into account in the implementation of the principles set forth below.

2. In its surveillance of the observance by members of the principles set forth above, the Fund shall consider the following developments as among these which might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market;

(ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance-of-payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance-of-payments purposes of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance-of-payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance-of-payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows; and

(v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements.

3. The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment.

PROCEDURES FOR SURVEILLANCE

1. Each member shall notify the Fund in appropriate detail within thirty days after the Second Amendment becomes effective of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member shall also notify the Fund promptly of any changes in its exchange arrangements.

2. Members shall consult with the Fund regularly under Article IV. The consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV. In principle such consultations shall take place annually, and shall include consideration of the observance by members of the principles set forth above

as well as of a member's obligations under Article IV, Section 1. Not later than three months after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV.

3. Broad developments in exchange rates will be reviewed periodically by the Executive Board, inter alia in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct special consultations in preparing for these discussions.

4. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and exchange policies, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its exchange rate policies.

5. If, in the interval between Article IV consultations, the Managing Director, taking into account any views that may have been expressed by other members, considers that a member's exchange rate policies may not be in accord with the exchange rate principles, he shall raise the matter informally and confidentially with the member, and shall conclude promptly whether there is a question of the observance of the principles. If he concludes that there is such a question, he shall initiate and conduct on a confidential basis a discussion with the member under Article IV, Section 3(b). As soon as possible after the completion of such a discussion, and in any event not later than four months after its initiation, the Managing Director shall report to the Executive Board on the results of the discussion. If, however, the Managing Director is satisfied that the principles are being observed, he shall informally advise all Executive Directors, and the staff shall report on the discussion in the context of the next Article IV consultation; but the Managing Director shall not place the matter on the agenda of the Executive Board unless the member requests that this procedure be followed.

6. The Executive Directors shall review annually the general implementation of the Fund's surveillance over members' exchange rate policies.

Chairman GIBBONS. Thank you, Mr. Fox. When we hear from the next witness, I want to ask you why the interest rates are so low in Japan, but I won't ask you that right now. I want to give the next witness an opportunity.

Go right ahead, sir.

STATEMENT OF RONALD L. DANIELIAN, EXECUTIVE VICE PRESIDENT AND TREASURER, INTERNATIONAL ECONOMIC POLICY ASSOCIATION

Mr. DANIELIAN. I am Ronald L. Danielian, executive vice president and treasurer of the International Economic Policy Association. I appear today on behalf of an association that has studied this issue since 1957, starting with a series of books on the balance of payments. My testimony, from which I will summarize two or three points, is in large part based upon a publication that was just released, entitled "U.S. Foreign Economic Strategies for the Eighties," which the committee has in its filings.

The first point is that the financial flows mentioned this morning and the disparity of interest rates just mentioned, have really caused, on a short and even a long-term basis, a deception in the balance of payments.

They have masked an overall trade deterioration by providing us with a nominal current account surplus, and I think this is important. It deceives policymakers into thinking that in overall commerce, we actually have a surplus, even though we do not. Table 1 of my testimony shows this. It is very important, because in some quarters, you do hear that as long as the total current account is in surplus or in slight deficit, the situation is not as serious as it might seem.

On a commercial basis, we just do not have a current account surplus.

Chairman GIBBONS. Would you explain that a little more? I don't have your chart in front of me.

Mr. DANIELIAN. It is attached to my testimony as chart No. 1, which shows that basically over the last decade, except for 1 year, which was after the 1974-75 recession, in commercial terms we do not have a current account surplus.

There are some statistical changes that were made which were purely accounting changes, but which inflated the current account substantially, and table 1 to my testimony shows this, Mr. Chairman.

Second, I would like to make the point that floating exchange rates have been viewed as an automatic adjustment mechanism. Yet, it is clear that they are not a panacea, that markets have a tendency to overreact as well as underreact, and that what is perceived to be positions of fundamental disequilibrium can endure for longer periods than were thought likely or desirable in the past.

To follow a theory that hands-off floating is the self-equilibriating panacea for U.S. trade problems will only build up more pressure behind protectionist answers as more workers lose their jobs to imports.

While the effect of exchange rate changes on the volume of U.S. trade is important, of equal importance is our net balance of trade, what we earn from exports and what we have to spend on imports in money terms.

If our terms of trade worsen, our economy will not benefit from the volume increases, and we could be pushed into an era of continuing deficits, which will create pressures for protectionist measures.

An analysis of the data in our book shows that there has been only a small correlation in money terms over a period of time between currency and trade movements for the United States.

The last point I would like to make is that the Federal Reserve Board in New York, in the summer issue of their quarterly review, has a very interesting article. It points to the fact that the depreciation of the dollar up through 1978 had a net positive effect overall on our trade account of about $33 billion, but that the appreciation of the dollar in the last 2 years has had a deteriorating effect on our trade balance of about $45 billion.

What we have is exchange rates today that are close to what they were in 1977-78 period. Yet, we are $12 billion behind. What seems to be happening is one step forward and two steps back.

The Federal Reserve bank study also shows that this will affect the U.S. economy by lowering the real GNP by about 1.5 percent, which was reiterated this morning by Mr. Bergsten.

In the future, U.S. trade policy must be interlinked with our efforts to achieve a higher defree of international cooperation, with closer coordination of fiscal, monetary and exchange rate policies.

Failing agreement on this between major nations, the GATT might be an appropriate vehicle for bringing trade complaints where a devaluation gives an industrial country an unfair advantage.

Likewise, the United States might want to consider a severely undervalued currency as grounds for use of GATT article XXIII, a nullification and impairment.

To do any less in the face of an import assault based on a misalined currency such as the yen will subject our political leaders to unacceptable pressures to restrict trade outside of established international rules.

Furthermore, we cannot continue to advocate hands-off floating and must work through joint action with the IMF in the industrial countries to manage exchange rates more where the differentials are not the result of basic economic forces. I would agree with what Mr. Bergsten said this morning, that you can't change the basic direction, the underlying direction of a currency, but certainly you can, in a sense, chop off the highs and the lows of the fluctuations.

As I said, we are today right back where we were in 1977–78 in most currency alinements. In the meantime we have had 20, 30, and even 40 percent changes.

As a recent policy statement issued by the group of 30 said, the effectiveness of intervention depends crucially on the market's perception of the degree of commitment by the authorities to achieving a certain outcome for the exchange rates.

Thank you, Mr. Chairman.

[The prepared statement and tables follow:]

STATEMENT OF RONALD L. DANIELIAN, EXECUTIVE VICE PRESIDENT AND TREASURER, INTERNATIONAL ECONOMIC POLICY ASSOCIATION

Exchange Fluctuation and the Yen

Mr. Chairman:

Thank you for giving us the opportunity to testify at your hearings on the causes and effects of the yen/dollar exchange rate relationship and its implication for U.S. trade policy. My name is Ronald L. Danielian and I am Executive Vice President and Treasurer of the International Economic Policy Association which is a non profit research organization supported by a select group of U.S. companies involved in international activities. We celebrate our 25th anniversary year in 1982 having dealt with the subjects of international trade, investment, taxation, foreign aid, raw materials and exchange rates over the past quarter century.

We have testified on many occasions before this committee on U.S. balance of payments investment and trade related policy issues. I appear here today not on behalf of any one of our members but on behalf of an association which has studied these international issues with a view toward the U.S. national interest. Our just published book entitled U.S. Foreign Economic Strategies for the Eighties* has a complete section dealing with floating exchange rates and U.S. trade. I will draw upon some of the research done for that publication in my testimony here today.

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* Westview Press, Boulder, Colorado, 1982, Stanley, Danielian and Rosenblatt.

It is very difficult for anyone to identify a specific single cause for a disequilibrium in exchange rates between nations. There are after all many factors involved in this question and in dollar terms a movement of the dollar does not always have the theoretically expected results.[1/] In volume terms to be sure a depreciation will increase U.S. exports, as occurred in 1980 for instance, and an appreciation will decrease U.S. exports. We are witnessing this in our trade volume flows with Japan as the dollar has reached heights that were last seen back in the 1977/1978 period. Nevertheless, even as the dollar depreciated through the mid 1970s, for example, in sharp reaction to its over valuation of the '60s, the United States sustained a cumulative trade deficit of 13.1 billion from January 1971 through December 1974. It was not until the aftermath of the '74-75 recession that the United States swung into a surplus position. Thus, it was the U.S. economic slow down in advance of that experienced by our major trading partners and a depreciating dollar that together reversed the trade deficits. It was in effect a combined reaction. Analyses such as the Wharton-Link model and the IMF World Trade model have attempted to sort out the factors involved in trade balance adjustments associated

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[1/] The U.S. Treasury noted in 1980 that the volume of U.S. exports increased with large credit given to dollar depreciation. The problem is that we have sacrificed our terms of trade. The unit value of our exports has increased less than that of our competitors. The country is exporting more real goods, getting less for them, is unable to cover import costs, and is suffering an inflationary bias due to depreciation. See Business Week, July 21, 1980, p. 88.

with floating exchange rates. They "show conclusively that year by year changes in the volume of imports and exports are dominated by variations in real aggregate demand."[2/] This suggests one of the key ingredients is, in fact, the health of the major industrial economies. Since most of the major countries in Europe are still in the throes of adjustments and recession and since Japan's growth has been substantially less than in previous periods, one of the major factors affecting U.S. trade, regardless of the higher value on the dollar, is the state of the world economy. While it is neither desirable nor feasible for the world to return to the fixed exchange rate system such as the one established under the Bretton-Woods system, it is also unrealistic and perhaps foolhardy to rely on floating exchange rates to bring about quick and relatively painless adjustments in the nations external balances.[3/] Our history has shown this doesn't happen.

Another problem concerns financial flows. In times of differing fiscal and monetary policies among major trading nations, financial flows do not necessarily reflect the longer term underlying strengths or weaknesses of a particular economy in terms of the basic factors such as inflation, trade balances, or current account balances. U.S. fiscal policy has been rather loose and U.S. monetary policy rather tight. As a result, we have had extremely high interest rates which have attracted hugh amounts of

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[2/] Jacques Artus and John Young, "Fixed and Flexible Exchange Rates; A Renewal of the Debate," Staff Papers, IMF, December, 1979, p. 669.

[3/] Erich Spitaller, "Effects of Exchange Rate Changes," Staff Papers, IMF, June, 1980, p. 320-348.

foreign capital. On a short and even long term basis, these flows have masked the overall trade deterioration by providing us with a nominal current account surplus. This can deceive policymakers into thinking that in overall terms, we are not as badly off as our trade deficit shows. However, in purely commercial terms, excluding statistical gimmickry we have actually had a current account deficit over the last several years. I have included as Table 1 our trade and current account balances over the last several years. The statistical gerrymandering noted in a footnote to the table shows that in commercial terms we have actually had a current account deficit.

Financial flows are influenced by relative interest rates between nations. At the present time our interest rates are lower than just six months ago and one would have expected the U.S. dollar to weaken in financial markets. However there have also been concurrent declines in foreign interest rates because overseas economies are also in recession and need to spur their domestic economic activity. However, as the November issue of Morgan Guaranty and Trust Company's World Financial Market noted, "European money market rates are now down by 1½ to 4 percentage points since June of this year, leaving short term interest rate differentials still favoring the dollar." I have reproduced as Table 2 the short term money market rates and central bank discount rates which were contained in the Morgan Guaranty article.

With regard to the Japanese yen, Table 3 shows the yen/dollar exchange rate starting on January 21, 1980 and in various months thereafter up to November 4, 1982. As can be seen, from January 5, 1981 to November 4, 1982 the yen depreciated (or the dollar appreciated) by 39.5 percent. The yen value at 277.55 to the dollar is now around the same rate it was at the end of 1977 and in 1978. Based on the 1981 hourly compensation of production workers in manufacturing industries in Japan the decrease in the value of the yen translates into an additional benefit of roughly $2.40 per hour to the cost of manufacturing between the United States and Japan. To place that kind of a shift in more meaningful terms for you and me as consumers, in January 1981 a $6,000 Japanese automobile that was valued at that time at 1.2 million yen could now cost $4,325.54. Of course the price doesn't drop to that level because the importer will consider in his pricing the fact that his profit margins were shaved very narrowly when the yen was last significantly stronger. Nevertheless the importer has almost $1,800 with which to lower the price of his product and increase his share of the U.S. market. The effect of this kind of relative trade advantage over a broad cross section of goods will be devastating when the U.S. economy returns to a normal growth pattern. The United States experienced a $15.8 billion trade deficit with Japan in 1981. For 1982 it is likely to be over $20 billion. As the U.S. economy comes out of its recession with a hoped for second half 1983 strong recovery, we are likely to have a trade deficit with Japan of over $30 billion for the year which could be half of our total 1983 trade deficit!

The political implications of this are enormous. The pressure of protectionism will be unrelenting and it will be difficult to check protectionist legislation which will be viewed as a short term answer for the long term problem. Unfortunately, this nation will suffer if its free trade principles are compromised in this way. There are, however, longer term implications in what has happened.

Floating exchange rates have been viewed as an automatic adjustment mechanism. Yet, it is clear that they are not a panacea, that markets have a tendancy to over react as well as under react, and that what are perceived to be positions of fundamental disequilibrium can endure for longer periods than were thought likely or desirable in the past. To follow a theory that hands-off floating is the self equilibrating panacea for U.S. trade problems will only build up more pressure behind protectionist answers as more workers lose their jobs to imports. While the effect of exchange rate changes on the volume of U.S. trade is important, of equal importance is our net balance of trade--what we earn from exports and what we have to spend on imports, in money terms. If our terms of trade worsen, our economy will not benefit from the volume increases and we could be pushed into an era of continuing deficits which will create pressures for protectionist measures here in the United States.

Analysis of the data in our recent book, shows that there has been only a small correlation in money terms between currency and trade movements for the United States. Where the dollar has depreciated from one year to the next, a beneficial trade movement would be expected to occur over time. A weakened dollar against one currency should be corrected by a reduction in our trade deficit with that country. Admittedly this pattern is not expected to be instantaneous but it should show up eventually if floating exchange rates are to be viewed as an effective mechanism for achieving trade balance adjustment. IMF staff studies have shown the adjustment period to be anywhere from 18 to 24 months.[4] Yet in practice, floating exchange rates have not helped as much as was expected. In addition there is an immediate inflationary effect[5] because with a devaluation, the pass-through of import unit values--import cost increases--occurs within one year.

An example of this lag response can be found in the U.S./Japanese trade balance (Table 4). From 1975 to December 1978 the dollar depreciated by about 34 percent against the yen. However our trade deficit with Japan steadily increased. Only in 1979 was there an improvement after dollar depreciations of 9.6 and 28.5 percent in the two preceding years (Table 5). The improvement was almost $3 billion but that seems minor compared with a 34 percent depreciation which, for instance, escalated imported car prices over time and created an inflationary impact associated with other imports. In addition, the world pressure on Japan to pursue a growth policy and accept quantitative controls on its exports probably had more to do with this correction than did floating exchange rates. For 1980 and 1981 there was a deterioration in the U.S. bilateral trade balance as the dollar first appreciated and then depreciated. Over the period from 1975 through 1981 (the year in which the U.S./Japan trade deficit reached $15.8 billion) the U.S. suffered five negative shifts totaling $17.1 billion and one positive shift of $3 billion in its balances of trade. Yet the dollar depreciated by 40.8 percent and appreciated only 9.9 percent over the period. This should have aided in a stronger positive shift in U.S. trade balances but it didn't. Thus we seem to lose more on the upside when the dollar appreciates than we gain on the downside when the dollar depreciates. This tendency is reinforced by the characteristics of the Japanese domestic trading system and the problems exibited by U.S. industries in trying to break into this market.

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[4] Ibid footnote 3.

[5] On January 29, 1981 Henry Wallich of the Federal Reserve Board noted that "the inflationary impulses emanating from a declining exchange rate are greater than had been thought." Some estimates have placed the inflationary effects of the 1978-79 dollar depreciation at over 2 percentage points.

The past appreciation of the dollar over the yen and other currencies will have a considerable impact in the next two years for it will increase our overall merchandise trade deficit. The Federal Reserve Bank of New York has estimated that by the end of next year there will be an increase in our trade deficit of up to $45 billion because of the appreciation of the dollar.6/ This comprises export sales which will be $35 billion lower and U.S. imports which will be $10 billion higher. The same study showed that the depreciation of the dollar up through 1978 contributed to a net favorable trade balance shift of approximately $33 billion. It is interesting that the 1978 depreciation of the dollar of 20 to 30 percent had less positive effect on our net trade balance than the $45 billion deterioration caused by an appreciation of the dollar by exactly the same amount. In fact, generally speaking, the dollar exchange rate is the same today as it was in 1977 and 1978. What has happened in the interim is that we are $12 billion

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6/ Federal Reserve Bank of New York, Quarterly Review, Summer, 1982, Volume 7 No. 2, pp. 1-9.

poorer. The Federal Reserve Bank study also shows that this will effect the U.S. economy by lowering real GNP by 1.5 percentage points which will have a negative job effect on the U.S. economy.

In the future, U.S. trade policy must be interlinked with our efforts to achieve a higher degree of international cooperation with closer coordination of fiscal, monetary and exchange rate policies. Failing agreement on this, the GATT might be an appropriate vehicle for bringing trade complaints where a devaluation gives an industrial country an unfair advantage. Likewise, the U.S. might want to consider a severely undervalued currency as grounds for use of GATT Article XXIII on Nullification or Impairment. To do any less in the face of an import assault based on a misaligned currency such as the yen will subject our political leaders to unacceptable pressures to restrict trade outside of established international rules. Furthermore we cannot continue to advocate "hands-off" floating and must work through joint action with the IMF and the industrial countries to manage exchange rates where the differentials are not the result of basic economic forces. As a recent policy statement issued by the Group of Thirty said, "the effectiveness of ... intervention ... depends crucially on the market's perception of the degree of commitment by the authorities to achieving a certain outcome for the exchange rates." [7] Thank you Mr. Chairman

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[7] Group of Thirty, The Problem of Exchange Rates, 1982.

TABLE 1

U.S. TRADE BALANCE, OFFICIAL CURRENT ACCOUNT AND CURRENT ACCOUNT ON ACTUAL TRANSACTIONS,[1/] OVERALL AND WITH JAPAN, 1971-1981, (in millions of $)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981
U.S. Overall Trade Balance	-2,260	-6,416	+ 911	-5,343	+9,047	-9,306	-30,873	-33,759	-27,346	-25,338	-27,889
Official Current Account	-1,433	-5,795	+7,140	+2,124	+18,280	+4,384	-14,068	-14,773	-466	+ 1,520	+ 4,471
Overstatement of[2/] Net Reinvested Earnings	+2,635	+3,963	+7,248	+6,712	+6,859	+6,037	+ 4,810	+ 8,760	+15,010	+10,850	+ 8,879
Current Account on Actual Transactions	-4,068	-9,758	- 108	-4,588	+11,421	-1,653	-18,878	-23,533	-15,476	- 9,330	- 4,408
U.S. Trade Balance With Japan	-3,225	-4,113	-1,309	-1,690	-1,690	-5,336	- 7,999	-11,581	- 8,632	-10,411	-15,802
Official Current Account w/Japan	-3,476	-4,821	-1,463	- 944	-1,410	-5,287	- 8,126	-11,782	- 8,746	- 8,997	-14,112
Overstatement of[2/] Net Reinvested Earnings	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	+ 51	+ 467	- 85	- 436	- 267
Current Account on Actual Transactions	-3,476	-4,821	-1,463	- 944	-1,410	-5,287	- 8,177	-12,249	- 8,661	- 8,561	-13,836

1/ Current Account on Actual Transactions includes the balance on goods and services and unilateral transfers but excludes accounting gimmicks as outlined in footnote 2.

2/ Reinvested earnings of American companies abroad are included in the government current account figures as if they were an inflow of funds thus inflating our exports of goods and services. These monies rarely return here, of course, since they are earned abroad, taxed abroad and used abroad. In the U.S. Official Capital Account the exact same ficticious "inflow" is substracted as an outflow so the total effect on our overall accounts is zero. The reverse of the above is true for reinvested earnings of foreign companies here in the United States. The figure on this line represents the difference between the ficticious export and import of these funds. A (+) represents the net amount that must be subtracted from the official current account; a (-) represents the amount that must be added.

N.A. Not Applicable: earlier Balance of Payments tables from Survey of Current Business do not inflate inflows or outflows by reinvested earnings. The accounting change was made in the mid-70's.

SOURCE: Survey of Current Business, U.S. Department of Commerce, June 1974, 1976, 1977, 1980, 1982.

TABLE 2

Short-Term Money Market Rates and Central Bank Discount Rates, 1982
(in percent)

SHORT-TERM MONEY MARKET RATES

	end-June	end-Sept	Latest
United States	15.2%	10.3%	8.7%
Canada	17.2	13.0	11.6
Japan	7.2	7.1	7.0
Belgium	15.8	13.0	12.8
France	14.9	13.8	13.2
Germany	9.4	8.0	7.2
Italy	20.4	18.5	18.8
Netherlands	8.9	7.9	6.8
United Kingdom	13.0	10.4	9.2

CENTRAL BANK DISCOUNT RATES

United States	12.00%	10.00%	9.50%
Canada	16.58	13.18	13.18
Japan	5.50	5.50	5.50
Austria	6.75	6.25	5.75
Belgium	14.00	13.00	12.50
France	9.50	9.50	9.50
Germany	7.50	7.00	6.00
Italy	19.00	18.00	18.00
Netherlands	8.00	7.00	6.00
United Kingdom	12.50	10.50	10.50

SOURCE: World Financial Markets, Morgan Guaranty Trust Company of New York, November, 1982, pg. 2.

TABLE 3

Yen Value in Relation to the U.S. Dollar on Specific Dates 1980 - 1982

November 4, 1982	277.55
September 7, 1982	257.45
August 9, 1982	262.30
March 5, 1982	233.90
December 31, 1981	219.80
September 4, 1981	229.70
August 10, 1981	236.10
March 5, 1981	208.90
January 5, 1981	199.00
September 29, 1980	212.40
January 21, 1980	240.90

SOURCE: Selected Interest and Exchange Rates: Weekly Series of Charts. Board of Governors Federal Reserve System, Washington, D.C., Selected Issues.

TABLE 4.
U.S. Merchandise Trade Balance with Selected Countries, 1974-81, (millions of $)

	1974	1975	1976	1977	1978	1979	1980	1981
Germany	-1,567	-306	-192	-1,399	-2,766	-2,259	-243	-858
Japan	-1,690	-1,690	-5,335	-7,999	-11,581	-8,632	-10,411	-15,802
United Kingdom	+583	+1,144	+947	+900	+802	+2,677	+2,970	-530
France	+670	+962	+1,031	+490	+190	+850	+2,277	+1,546
Canada	-552	+1,827	-139	-1,112	-2,323	-330	-1,045	-2,099

Source: Survey of Current Business, June 1977, 1978, March 1981, and Monthly Report of the Deutsche Bundesbank, December 1978.

TABLE 5.

Change in U.S. Trade Balances, Year to Year, with Change in U.S. Dollar Exchange Rate for Selected Countries, 1974-81, (millions of $ and percent)

	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1981
GERMANY							
Trade change	+1,261	+114	-1,207	-1,367	+507	+2,016	-615
$ Currency change	-4.9%	+2.5%	-7.8%	-15.8%	-9.4%	-1%	+22.7%
JAPAN							
Trade change	0	-3,645	-2,664	-3,582	+2,949	-1,779	-5,391
$ Currency change	+1.8%	-0.1%	-9.6%	-28.5%	+4.8%	+3.3%	-2.6%
UNITED KINGDOM							
Trade change	+561	-197	-47	-98	+1,875	+293	-3,500
$ Currency change	+5.3%	+23.1%	+3.4%	-9.9%	-10.6%	-9.6%	+11.1%
FRANCE							
Trade change	+292	+43	-541	-300	+660	+1,427	-731
$ Currency change	-10.9%	+11.5%	+2.9%	-9.2%	-5.8%	-1%	+28.7%
CANADA							
Trade change	+2,379	-1,966	-973	-1,211	+1,993	-715	-1,054
$ Currency change	+4%	-3.1%	+7.8%	+6.8%	+2.7%	+.2%	+2.5%

Source: Table 4 and The Federal Reserve Bulletin, March 1977, January and December 1978, June 1980, 1982.

Note: The percentage change in U.S. dollar exchange rates is based on yearly average exchange rates for 1974-75; 1975-76; 1976-77, etc.

Trade change is the difference between the U.S. trade balance for each of the years listed from Table 4. A (-) indicates a deterioration in the U.S. trade account from year to year; a (+) indicates an improvement.

$ Currency change is the U.S. dollar depreciation (-) or appreciation (+) from year to year.

Chairman GIBBONS. Let me go back to that question now. Why is the Japanese interest rate so low?

Mr. FOX. Mr. Chairman, I started life as an historian.

Chairman GIBBONS. They have a low inflation rate now, that is one thing, but what else?

Mr. FOX. I started life as an historian and moved into this economics business by mistake, I think, but I still tend to look at things historically.

I think, historically, Japan came out of World War II thinking of itself as a very poor country. Therefore, it had to husband its resources. It had to not move too fast on infrastructure or social benefits, and it had to borrow abroad to rebuild itself.

In the process, it created a financial system and a savings system that produced more savings per capita on whatever basis one counted than any other society. But still interest rates were relatively high in Japan until recent years, because the inflation rate was high in Japan. Furthermore, Japan used so much capital that the cost of capital was high because the demand was high.

Somewhere between 1965, 1968, 1971 and the present, Japan moved into a capital-rich situation relative to its needs, not because it has fully met all the needs of its people with respect to infrastructure, but because it has put borrowing by the chosen industries, which means the industries meant to be most competitive worldwide, at the head of the list.

The only thing it has put equally high on the list or close to that first position on the list is borrowings by the Japanese Government itself to finance the public debt.

The Japanese Government today borrows at 5.5 or 6 percent. In the past, Japanese bond houses and pension funds have been content to go to the Bank of Japan or to the appropriate agent, and buy the bond at 5 or 6 percent. That is absurd in the face of the removal of capital controls in Japan, which took place in a substantial way, not completely, but in a substantial way, in recent years, and a lot of Japanese money has moved to New York to take a 14- or 15-percent money return.

That explains the weakness of the yen, but still enough money remains in Japan, because savings are high, and because of the system of allocation of money to the highest priority item, that interest rates can be low relative to the system of priority of needs established by the Japanese authorities in cooperation with the banks and industry.

Now, the insulation of Japan from the world monetary scene makes it impossible for even the best American company to go to Japan and borrow $200 or $300 million at that 6 or 7 percent, which any rational American company would want to do.

The way that situation evolved simply is that one must stand in line at the Ministry of Finance, and go through a turnstile, and the Japanese authorities will approve one or possibly two loans per month by foreigners wishing to borrow in the Japanese market. That is one reason why interest rates in Japan are not bid up.

A second reason is that those who would and perhaps could borrow in Japan think, "My God, the yen will have to rise, and if I earn my yen only through dollars, I will have to pay back the loan in more expensive dollars," so they are not so keen to go to Japan under these conditions.

A third condition exists also, which causes concern about borrowing in Japan or putting money in Japan and that is that exchange controls might be reimposed a la Bergsten. So even though the Japanese intention might be to smooth out the exchange rate fluctuations, the possibility of reimposition of exchange controls makes the whole financial situation uncertain. As a result the Japanese money market is not tapped by others, thus not driving up the yen rate to the extent that would be the case in the United States or London or Frankfurt or some other foreign exchange market.

I think the Japanese recognize the advantages of cheap money. If you are going to run an industrial policy designed to promote new investment in higher value-added industries, it is a great thing to be able to borrow as much money as you can use effectively, and it is a great thing to be able to sell your products abroad at a low price.

As I said, the Japanese authorities really do not want a cheap yen, as cheap as the one we have today, but historically Japan seems incapable of taking the lead on a world issue of this type, and I think one would have to conclude that that lead must be taken by America.

Chairman GIBBONS. The picture you have painted is one that there is no chance of solution?

Mr. FOX. No; I don't believe so. If you have an initiative from the United States and Germany to take the necessary steps to reestablish a correct alinement of currencies, in order to facilitate the further resumption of economic growth in our countries, and in order to keep the world trading system from deteriorating further, I think the Japanese interest in the world trading system is such that they will move to accommodate to this proposal.

Now if they undertook to support the yen along with joint intervention by the United States and others say at 200, they would take the necessary steps to achieve that result. One of the necessary steps would be a rise in interest rates. Japan would have to permit interest rates to rise or else put on exchange controls.

I think Japanese funding managers, money managers, are no longer so content to invest 5 or 6 percent in Japan rather than 14 or 15 percent in New York, and I think under these circumstances Japanese authorities would accommodate to the reality, and interest rates would tend to rise in Japan and tend to fall in the United States. We have ample domestic reasons to want to have a lower interest rate structure in this country anyway.

I paint a picture that I consider fairly hopeful. I think the conjunctural situation with respect to both interest rates and the desire of the Japanese to avoid pulling the whole international trade system down makes this a very propitious time to suggest what I would call a modification, or to use a favorite term these days, a midcourse correction in the regime of managed floating rates.

Chairman GIBBONS. If you were sitting on my side of the table, what would you do now?

Mr. FOX. I think I would study that import surcharge that you suggested this morning, and make sure that it would be understood, whether it be applied on an MFN basis or on any other basis. I think I would consider other measures, including suggestions from Mr. Volcker as to how powerful he would view the closing of the interest rate gap itself to be as a factor in bringing this misalinement to an end. And I think I would consult other international organizations and authorities, including those in Europe, who find American high interest rates a terrible drag on the economic development of their own countries, because their interest rates are substantially determined in New York.

Mr. SCHULZE. If the gentleman will yield?

Chairman GIBBONS. Certainly.

Mr. SCHULZE. Would you use that import surcharge as a hammer over their heads for negotiating purposes, or would you go ahead and do it?

Mr. FOX. I said at the very beginning, I would not use the import surcharge. If I were President, I would direct the Secretary of the Treasury to make the suggestion to German and Japanese authorities that we try to coordinate our exchange rate policies and our other policies relating to macroeconomics, including interest rate policies, to produce a rational relationship among the three currencies. And I think that would work.

I think that is a rational proposal. I think it would work, and you would never have to face the prospect of using a surcharge either to force the Treasury or to force Japan to take certain steps.

I think the proposal I have outlined is a rational adjustment in the system of floating rates.

Chairman GIBBONS. Let's go back to the steel question.

You say the Japanese are bringing steel tubing into this country, not selling it but putting it in inventory; is that right?

Mr. MCGRANN. That is what we have been told, Mr. Chairman, by our customers.

Chairman GIBBONS. Are your customers actually buying the Japanese pipe, or what are they doing?

Mr. MCGRANN. We understand that there are two phenomenons going on; that the trading companies are maintaining ownership of the pipe, that is, the Japanese trading companies, so the first sale must be from the steel mill to the trading company.

The second phenomenon is that the trading companies themselves are selling the pipe to distributors on consignment, that is, they will allow the distributor to sell the pipe, and if at the end of a 9-month or 1-year period the pipe is not sold, the trading company will take the pipe back into ownership.

My point is, Mr. Chairman, that as we are shutdown as an industry, this phenomenon is occurring, and there doesn't seem to be any remedy under current trade law for us to address ourselves to.

Chairman GIBBONS. That is interesting.

Have you ever seen that go on before?

Mr. MCGRANN. No, Mr. Chairman, I haven't. I have been in the steel industry for 19 years, and I have never experienced this kind of a phenomenon, when the American mills, the other importers, Europeans and Third World countries, are throttling back, as the market has evaporated, while at the same time Japan or any importing country has flooded the market with their goods.

Chairman GIBBONS. Does any other member of the panel understand that this has ever happened before? Is this something new, or is it that you just haven't heard of it before?

Mr. FOX. Mr. Chairman, I wouldn't comment on the steel situation, but with respect to machine tools, I know there is a situation where, I have been told by a very responsible person in the machine tool industry, there are between 5 and 10,000 numerically, controlled machine tools of Japan in this country remaining to be sold.

Chairman GIBBONS. I have been told the same thing. It is going to start as soon as the administration finishes with the case that they have now. I am going to have a public hearing on that, on the machine tool question, because it looks like to me there has been some chicanery there, through the motorcycle and bicycle slush fund, toward an off-book, off-budget, in-the-closet, under-the-table type of transaction, done with a great deal of cleverness. It really worries me.

Mr. Schulze.

Mr. SCHULZE. Mr. Chairman, to followup on your last question, it seems to me when we did pass the legislation implementing the Tokyo round, at the time I raised some questions on the possibilities of kick-backs, rebates, other kinds of subsidies.

Chairman GIBBONS. Yes; I recall that.

Mr. SCHULZE. Which we had no way of thinking of at the time, but there ought to be some way that we should be able to cover them, and I don't remember that we did thoroughly. It seems to me that this situation is an extension of it.

You asked the question, how do you pay the interest on $1 billion worth of pipe that is being stored, but I don't think you answered it? Do you have an answer?

Mr. MCGRANN. Mr. Schulze, I am sorry I don't. I would say this: that we couldn't do it, nor do I think our domestic competitors could do it.

Mr. SCHULZE. Well, being subsidized, I think you might have a case, if you could find out how that——

Mr. MCGRANN. That is why I indicated, Mr. Schulze, that we were pursuing to the best of our ability whatever remedies we had, but wanted you to consider this rather unusual situation as we view it.

Mr. SCHULZE. The other thing, of course, is that it is a damn good merchandising technique. You have the money, and have the faith in the market, it is a very clever way of penetrating the market and dominating it.

Mr. MCGRANN. That certainly is true and our unemployment figures attest to that at the present time.

Mr. SCHULZE. I still wish these hearings were being held in other countries and we were doing some of these things. I think we have lost some of our Yankee ingenuity. Maybe it is because of a basic financial lack of a sound basic structure that we are losing some of that sound structure. I wish we would get back to that.

Anyhow, how much influence in the currency prices do traders or speculators have? Is it minimal? Are they just playing the market forces, or do they actually have an influence on the valuations of the currencies.

Mr. Fox. I think that it is very difficult to suggest that the market is not responsive to supply and demand at any one moment for a particular currency. Certainly there is a tremendous demand for dollars at this time which tends to push up the value of the dollar.

I have just outlined one factor in the international system that tends to push up the value of the dollar, namely, the high interest rates and safe haven effects associated with high interest rates, but the transaction also pushes up the value of the dollar.

If two-thirds of the world trade takes place in dollars, and if trade between England and France is financed via the dollar, that creates additional demand for dollars. That makes the dollar a stronger currency, and basically the dollar has been a very, very strong currency during most of the postwar period, with the exception of that strange period in 1978 and 1979, and at the very end of the Breton Woods system in August 1971.

Those circumstances I think could be explained by the conditions that then prevailed, but I don't believe the rates that now exist between say the dollar and the yen are basically the rates established by speculators. They are basically the consequence of two systems that don't appreciate properly a worldwide system that tends to push up the value of the dollar. Added to this are conditions in our own country that create very high interest rates that operate in that direction, and the opposite kind of system in Japan, which tends to insulate that country's interest rates in financial markets from the world scene. The combination of those two factors produces the untoward result of this gross disparity in value between the yen and the dollar.

Mr. Schulze. I have never been a big advocate of returning to the gold standard, but what would that do in this instance?

Mr. Fox. I think it would make a lot of mischief. I think to tie the value of the three currencies to something else that varies in a rather peculiar way that none of us can predict probably would add greater uncertainty rather than cure the question of uncertainty in the system.

Mr. Schulze. What is the effect of the current relationship—or the relationship between the currency market and gold? Is there one?

Mr. Fox. I think I would like to beg off on that. I have the feeling that the gold market is responsive to a number of conditions, including conditions in major currency markets.

Generally speaking, something that immediately strengthens the dollar seems to weaken gold, but I would hesitate to suggest that I could offer any serious observations on that.

Mr. Schulze. What influence does the quantity of yen have? How tightly is that controlled?

Mr. Fox. Japanese monetary policy has been remarkably successful if viewed in the context of the Japanese business cycle.

Generally speaking, to my knowledge, the best examples of successful monetary policy on a national level are shown in Japan.

When there is an inflation and they have turned on the monetary screws, turned down the monetary screws, they have tended to slow down domestic activity. But not to worry, exports would increase, the fixed exchange rate system, the par value system of

Bretton Woods, that is, until August 15, 1971 assured Japan most of the time of an undervalued currency.

So as they tighten the screws on the domestic aspect of the economy, exports would pick up and lead the way to a recovery. The relatively close monetary system in Japan was a great facilitation to the role of the Treasury and the Bank of Japan in managing monetary policy.

I can't tell you now, I don't know, how the Japanese establish monetary targets and precisely how those targets are related to domestic needs. But I think if you were to look at Japanese monetary policy just from the Japanese standpoint—forget about the effect on the world and the world trading system and the exchange rate—the Japanese have been able to manage their monetary policy very well in the interests of smoothing out their business cycle and cooling down an overheated economy.

The fact they have this low inflation rate now is in great measure attributed to their handling of monetary policy, notwithstanding the fact that the cheap yen tends to cause their imports, including oil, to be rather expensive.

Mr. SCHULZE. Mr. Fox, would you say because the Government debt is financed at 5.5 to 6 percent that the saver, the citizen who is saving is subsidizing the Government debt?

Mr. FOX. I think without doubt that a similar situation could not prevail in a country in which the consumer realized that he was getting an inadequate return for his money.

I think that to refer to that as the consumer subsidizing the Government's debt is certainly one way to look at it.

Mr. SCHULZE. It seems to me the Japanese have used this technique very successfully in other areas, building up production; they keep prices high domestically until they reach certain productivity levels and then expanding into foreign markets so they are doing it with their fiscal policy as well?

Mr. FOX. I think that is correct. I think the Japanese have a certain confidence in their society and in their Government and in their academic institutions that they have figured out a pretty good system from the Japanese point of view and are reluctant to see it changed too rapidly.

Certainly internationalization of the yen, which was suggested this morning as an appropriate step, is an appropriate step from the international point of view, but it would create headaches for the Paul Volcker of Japan.

I think the Japanese could be induced to go that way if they felt it was necessary in order to support their interests in the international trade and monetary system, but if not, given certain inducements and requirements, I think they would hold off that decision as long as they could and remain masters of their own monetary fate.

Mr. SCHULZE. Thank you.

Thank you, Mr. Chairman.

Chairman GIBBONS. Mr. Pease?

Mr. PEASE. Mr. Chairman, are you going to break for the vote?

Chairman GIBBONS. Whatever you would like to do.

Mr. PEASE. We have another panel yet this afternoon?

Chairman GIBBONS. Yes. We have the administration.

Mr. **Pease**. If I can ask one question, I think that would do it. Maybe we could then go on to the next panel.

I am particularly interested in the discussion from Mr. McGrann's testimony about shipments of tubular steel.

I am sorry I was gone for a good bit of the time, but apparently you made a reference to some new arrangement where trading companies, Japanese trading companies, maintain ownership and then sell to distributors on consignment?

Mr. **McGrann**. That is correct. That is what we have been told, Mr. Pease, by the distributors.

In other words, the distributors are in a position of no risk. They buy the material. The material changes ownership, but there is no risk because if they don't sell the pipe to an oil company, the Japanese trading company takes it back at the end of 9 months or 1 year.

Mr. **Pease**. I see.

Mr. **McGrann**. That allows the Japanese to continue to ship into this country while we are shut down and build these stocks and either maintain ownership themselves at the trading company level, or legally transfer ownership, but in reality remove the distributor from any risk that he might have in ownership.

Mr. **Pease**. Is there anything that would prevent American steel companies from doing the same thing?

Mr. **McGrann**. It would be financing that inventory, Mr. Pease. It costs us money, just as it costs the Japanese to manufacture the product. If we are not paid cash to cover our costs of manufacturing, we are indeed financing the inventory. That is, of course, what is of concern to us about this particular phenomena.

Mr. **Pease**. Do you view that as an unofficial subsidy of the steel industry in Japan?

Mr. **McGrann**. That would be my personal view, Mr. Pease. I am not sure that that is necessarily legally the view that would be taken, but what I put forth in my testimony was that either there was some sort of subsidy or that there was someone carrying the cost of a $1 billion inventory that put us at a competitive disadvantage to the point where we shut down and they continued to operate.

Mr. **Pease**. What about sales price as far as the customer is concerned?

What is the price of Japanese tubular products compared to American tubular products?

Mr. **McGrann**. It has tracked very, very closely the past 2½ years, the U.S. domestic price.

The problem we have now is to really and truly find out what the actual transaction price is because, you see, the oil companies are not taking ownership.

The oil companies are operating out of their own stocks. They are not taking the ownership, so that the trail of distribution becomes slightly complex and I can't truly answer what the selling price of Japanese tubulars is now because it in some ways is irrelevant. It is going into stock as opposed to going into the ground in a well.

Mr. **Pease**. I see. Thank you very much.

Chairman GIBBONS. It is, in effect, some form of subsidized financing? You are not sure what kind it is?

Mr. McGRANN. That is how I would categorize it, Mr. Chairman.

Chairman GIBBONS. Yes?

Mr. FOX. Mr. Gibbons, if I might make an observation, this is by way of suggesting that the Government witnesses might comment on it. A distinguished group of economists known as the Group of 30, individuals such as Mr. Witteveen, the former banking director of the IMF, Henry Wallich, in his private capacity, and others, have put out a series of international monetary reports.

Last spring they put out one which contained the following statement. This is not a quote; it is a paraphrase.

An overly strong currency maintained for an overly long period of time is a prescription for deindustrialization.

In reading that report, many of us thought they were referring to the United Kingdom. I would suggest they are referring to the United States or at least the situation refers to the United States at the present time.

Mr. DANIELIAN. I would like to make a point with regard to the steel case. I think it also shows that this is not just a currency fluctuation and exchange problem between the United States and Japan.

There are basic trade problems. If there is indeed a subsidy involved in the holding or financing of this inventory or stock, that is a basic trade problem and is outside——

Chairman GIBBONS. It would seem to me to be a basic trade problem. It is either dumping or subsidy, one of the two.

It is a way of disguising your price by your financing terms. I hope someone will follow through on it. It is the time value of money.

You give somebody a guaranteed buyback, or a deferred payment——

Mr. McGRANN. Mr. Chairman, with your permission we would like to ask if we might suggest some language or some—to your staff regarding this matter, if we might at a later time?

Chairman GIBBONS. Sure. We would be glad to have your suggestion. We hope to find a solution. If what you say is correct, it is already a violation of our existing law. They are disguising their price by giving you excessive amounts of credit or else somebody is subsidizing it somewhere.

I hope it is not like the motorcycle/bicycle racing pool we recently became aware of. If it is, we are going to get to the bottom of it.

Thank you all very much.

We will hear the administration witnesses just as soon as I get back from the vote.

[Recess.]

Chairman GIBBONS. Before we go to the next part of this hearing, I would like to state the Chair has received a number of letters from other Members of the Congress—both the House and Senate—supporting these hearings.

At this point, I will make them part of the record.

[The letters follow:]

U.S. SENATE,
Washington, D.C., November 30, 1982.

Hon. SAM GIBBONS,
Chairman, Subcommittee on Trade, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I commend the Trade Subcommittee for taking notice of the very serious problems posed for American companies and their workers by the current imbalance in the Yen/Dollar relationship. Illinois businesses in particular have been hard hit by the strong competitive pressures posed by foreign exporters, particularly the Japanese. Our companies and their workers have responded by trimming costs, improving productivity, and in general putting greater value in American products.

Despite these efforts, U.S. export strength is being diminished by a factor over which business and labor have no control. That factor is the imbalance between the American dollar and the Japanese Yen. For a number of reasons, the Yen continues to trade at a significantly undervalued level in comparison to the U.S. dollar. This exchange rate differential produces significantly lower transaction pricing for Japanese products. Consequently, consumers—in both domestic and foreign markets—are faced with much higher relative costs for U.S. goods than for those made in Japan. Additionally, the Yen/Dollar difference results in lower corporate sales and profit levels, and—more importantly—losses of American jobs.

It is imperative that the Governments of the United States and Japan immediately address the problem of the Yen/Dollar imbalance before the export prominence of the United States is permanently impaired. As you may know, I have requested Congress' General Accounting Office to take a hard look at the Yen/Dollar exchange rate. I will be pleased to share this study with you and the Committee when it is completed.

I applaud the initiative taken by the Trade Subcommittee and urge that this matter receive indepth consideration until we have a complete understanding of the reasons for it.

Sincerely,

CHARLES H. PERCY,
U.S. Senator.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., November 29, 1982.

Hon. SAM GIBBONS,
Chairman, Trade Subcommittee of the Committee on Ways and Means, Washington, D.C.

DEAR MR. CHAIRMAN: Your hearings on Japanese trade and international monetary evaluation are most timely and necessary.

The committee staff has invited representatives of CF&I Steel of Pueblo, Colorado, to participate in the proceedings.

Mr. Chairman, the steel unemployment situation in my district is critical. Mr. McGrann and Mr. Overtree will tell your committee how the subject at hand bears on the family situations in Colorado.

Thank you for your interest and courtesy.

Sincerely,

RAY KOGOVSEK,
Member of Congress.

Chairman GIBBONS. Our next panel of witnesses will be Mr. Niskanen, Mr. Lawson, and Ms. Constable. Mr. Niskanen.

STATEMENT OF WILLIAM A. NISKANEN, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. NISKANEN. Mr. Chairman, I value this opportunity to address the issues raised by the exchange rate between the dollar and the Japanese yen. In recent months, many people have asserted that the yen is "undervalued," that the exchange rate is maintained below the "natural" rate by policies of the Government of

Japan, and that some change in policy by the United States and Japanese Governments is necessary to restore this "natural" rate.

These assertions reflect an increasing concern about the present and potential competitiveness of many sectors of American industry—a concern that we all share.

These several assertions, however, are not consistent with the available evidence. My brief statement today summarizes the evidence that bears on these several assertions. Three questions are addressed: Has the yen been generally undervalued?

Second, is the yen undervalued now? And third, have the policies of the Government of Japan, on net, weakened the yen? The evidence that bears on these questions has recently been prepared from generally available data by staff of the Treasury Department and the Council of Economic Advisers.

First, has the yen been generally undervalued?

A general undervaluation of the yen would be most directly manifested by a large current account surplus or by an unusual accumulation of international reserves. As the industrial country with the highest domestic saving rate, Japan should be expected to have a current account surplus, that is, to be a net lender to other countries.

Any consistent undervaluation of the yen would lead to an even higher current account surplus. Over the period from 1973 through 1981, however, the Japanese current account surplus was relatively small, averaging 0.15 percent of GNP—less than that of the United States over the same period—0.16 percent—and much less than that of Germany—0.45 percent.

A general undervaluation of the yen would also be reflected by a rapid accumulation of reserves, at a rate higher than would be consistent with rising prices and a growing volume of trade. Japan has accumulated reserves since the beginning of floating exchange rates but not, however, at an exceptional rate.

Japan's reserves have increased by 130 percent since 1973, compared with a worldwide increase of reserves of 139 percent in this same period. Neither the current account data nor the reserve data, in summary, are consistent with a general undervaluation of the yen during this period of floating exchange rates.

Second, is the yen undervalued now?

The recent depreciation of the yen—until about a month ago—also led to concerns that this decline exacerbated the effects of the recession in the United States and reduced the effects in Japan. As noted in Under Secretary Sprinkel's testimony to this subcommittee in October, however,

> * * * developments in the yen/dollar exchange rate are not unique. Since the dollar entered its most recent period of generalized strength in mid-1980, most major currencies have depreciated against the dollar, and the yen has not been the weakest. The dollar has appreciated by 78 percent against the French franc, 46 percent against the German mark * * *, and only 22 percent against the Japanese yen.

Even though we do not believe that purchasing power parity measures are on accurate guide to equilbrium rates of exchange, Treasury and the CEA staff have estimated the relative depreciation of these three key currencies on a purchasing power-parity basis. At best, we recognize that this procedure provides only a rough approximation to the "natural" exchange rate, because numerous other conditions also affect this rate.

Using the whole period 1973-81 as a base and the consumer price indices as deflators, the yen appeared to be undervalued by around 15 percent in July of this year, but the franc and the mark both appeared to be undervalued by around 25 percent. The yen is now somewhat stronger than in July, reinforcing this general pattern.

In summary, the yen has depreciated relative to the dollar but has appreciated relative to other major currencies—on both a current dollar and a constant dollar basis. The exchange market conditions since mid-1980 are best described as a dollar phenomenon, not a yen problem.

Third, have Japanese policies, on net, weakened the yen?

Real exchange rates—as with real interest rates—are substantially determined by market conditions, not government policies. As noted in the testimony by Under Secretary Sprinkel,

> It is important to recognize the sheer size of exchange markets. This very size creates potential forces far exceeding the ability of governments to control, direct, or manipulate—even if they knew the "right" rate or thought they did.

Nevertheless, it is possible to identify the direction of the effect of several policies by the Government of Japan on the exchange rate. These several policies include trade policies, financial policies, and direct exchange rate policies.

Japanese trade policy has had a mixed effect on the value of the yen. In the last 2 years, the Government of Japan has implemented two rounds of tariff reductions on manufactured imports and a restraint on automobile exports. These policies—in part in response to pressures by the United States—probably weakened the yen.

At the same time, the continued restraints on imports of services and agricultural products have supported the yen. The administration has appropriately pressed for further opening of the Japanese domestic market, but it is important to recognize that such actions would further weaken the yen.

Japanese financial policy has also had a mixed effect on the value of the yen. A high rate of money growth and the recent relaxation of some of the controls on capital flows have probably weakened the yen. The very large government deficit, however, and the increase in domestic interest rates, in contrast, have probably strengthened the yen. The administration has also pressed for further opening of the Japanese capital market, but it is again important to recognize that such actions would probably weaken the yen in the short run, unless such actions lead to a substantial use of the yen as an international currency.

Data on Japanese intervention in the foreign exchange market are not reported to the public. The available data on the Japanese reserve position, however, reflects a consistent pattern of intervening to stabilize the real exchange value of the yen—by acquiring reserves when the yen is relatively strong and reducing reserves when the yen is relatively weak.

The reserve data suggest that the Government of Japan has intervened vigorously this year to support the yen. Total Japanese reserves have declined by $5.6 billion through the first 10 months of this year, and their total intervention to support the yen is undoubtedly larger.

The recent depreciation of the yen thus reflects a combination of conditions that has dominated the strong direct exchange market intervention to support the yen.

In conclusion, available evidence is consistent with the following conclusions:

The yen has not been consistently undervalued.

The yen is not now undervalued, relative to major currencies other than the dollar.

The policies of the Government of Japan have not, on net, weakened the real exchange value of the yen.

As mentioned before, recent exchange market conditions are best described as a dollar phenomenon, maybe even a dollar problem, but not as a yen problem.

Chairman **Gibbons**. Thank you.

Our next witness is Mr. Lawson.

STATEMENT OF EUGENE K. LAWSON, DEPUTY ASSISTANT SECRETARY FOR EAST ASIA AND PACIFIC, INTERNATIONAL TRADE ADMINISTRATION, U.S. DEPARTMENT OF COMMERCE

Mr. **Lawson**. Thank you, Mr. Chairman, members of the subcommittee. The yen/dollar exchange rate is the focus of growing attention in discussions of United States-Japan economic relations.

Our current trade frictions with Japan are in many ways like those of 1971–72 and 1977–78. They do appear to repeat a historical pattern in which severe U.S. merchandise trade imbalances with Japan often coincide with dramatic exchange rate movements, and business cycle fluctuations.

At the same time, the present problem is distinctly unlike previous episodes. In this instance, the merchandise trade imbalance has not led to adjustment through yen appreciation. Instead, the yen has continued to depreciate. Moreover, the weaker yen, by making Japanese exports to the United States more price competitive and U.S. exports to Japan less so, may have made a bad situation worse. This factor draws attention to exchange rate effects on trade balances and relative competitiveness.

Now, in order to understand this problem, we need to ask at least five fundamental questions:

First, is the yen undervalued? That is, is there a fundamental misalinement of the two currencies?

Second, if so, what are the underlying causes of this disparity? And especially, is there evidence of official intervention to defeat classic mechanisms?

Moving from causes to effect, we can ask:

What, if any, is the relationship between an undervalued yen and the U.S. deficit on bilateral trade?

Finally, what has been, and is likely to be, the effect on U.S. trade competitiveness in Japan, in the United States, and in third country markets?

Today I would like to summarize for the subcommittee my views on these questions. I will conclude by placing the yen/dollar exchange rate issue in the context of our efforts to liberalize the Japanese market for goods, services, and capital and to enhance overall U.S. export competitiveness.

IS THE YEN UNDERVALUED?

This is a difficult concept to establish. The chart which accompanies my submission approaches the question from the direction of an overvalued dollar.

In this exhibit overvaluation is measured as the ratio of the actual exchange rate to the hypothetical exchange rate which would maintain the same level of export price competitiveness as existed in 1973. Thus, when the index reaches 1.2, it indicates that the dollar is overvalued by approximately 20 percent relative to the other currency.

Using this methodology, IMF data through the second quarter of 1982—the latest available—suggest that the yen is undervalued—or the dollar overvalued—by approximately 20 percent. However, readings for other currencies show the mark undervalued by about 30 percent and the franc undervalued by about 28 percent.

Thus it appears that, if the yen is undervalued, there is no reason to assume that it is more undervalued than other competitor currencies. On the contrary, two other major currencies appear to be more out of line than the yen.

WHAT ARE THE CAUSES?

The underlying causes of currency misalinement are complex. In the case of the yen, the recent depreciation parallels the appreciation of the dollar vis-a-vis all major currencies which has resulted from higher U.S. real interest rates and the preference of investors for U.S. assets during periods of political and financial uncertainty.

In the case of Japan, it appears that a lower current account surplus than expected has also been depressing the yen. But the major factor appears to be the overshadowing of the current account surplus by Japan's capital account deficit. Capital flows in and out of Japan have increased dramatically in recent years due in part to significant liberalization, but the outflows have been much greater than the inflows. With the exception of 1980, the Japanese capital account has been in substantial deficit since 1978.

Specifically, it should be emphasized that there is no evidence that the Government of Japan has intervened to maintain an artificially depressed yen as a stimulus to export sales—or for any other policy consideration. On the contrary, the Government of Japan has tried—unsuccessfully—to support the yen. Japanese authorities have intervened vigorously in exchange markets this year in support of the yen.

WHAT IS THE IMPACT ON THE BILATERAL DEFICIT?

As a general observation, it is obvious that a weaker yen—by making Japanese exports to the United States more price competitive and U.S. exports to Japan less so—tends to worsen our bilateral trade deficit with Japan, which last year was $16 billion and this year will be about $18 billion.

Beyond this, though, it is difficult to determine exactly how much of the current imbalance can be attributed to exchange rate changes. The answer depends in part on the time period in question, on the degree of shift actually experienced or hypothesized in the rate, and the model, the assumptions, and the methodology used to generate statistical answers. Generally, our research indicates that yen/dollar exchange rate movements have not had a major impact on the bilateral imbalance.

Over the longer term, we have found that from 1974-77 the actual deficit grew even while the yen was appreciating. Since late 1978, however, growth in U.S. imports from Japan—and the bilateral deficit—have actually coincided with depreciation of the yen.

Depreciation of the yen appears to have had little effect on U.S. exports to Japan. This may be accounted for by the fact that U.S. exports to Japan are composed mainly of food items and raw materials which are relatively unresponsive to higher relative prices.

In general, the effect of yen depreciation is greater on U.S. imports from Japan than on U.S. exports to Japan.

Chairman **Gibbons**. Let me interrupt you right there. How about the impact on third markets?

Mr. **Lawson**. I will be covering that in the next couple of pages.

Chairman **Gibbons**. Fine.

Mr. **Lawson**. In terms of the more recent undervaluation of the yen, our research indicate[illegible]t United States-Japan trade in 1981 may not have been respon[illegible] yen/dollar movements. A simulation of a 20-percent app[illegible]f the yen in 1981 did result in increased U.S. exports [illegible] Ja[illegible]t the bilateral trade deficit was only reduced by about [illegible] b[illegible]ven if the simulation assumptions were changed, indica[illegible]hat yen appreciation in the short term cannot be exp[illegible]duce the bilateral deficit by more than $2 to $3 billion.

WHAT IS [illegible]E IMPACT ON U.S. COMPETITIVENESS?

The extent to which exchange rate movements can affect the relative price competitiveness of specific U.S. industries will depend on the degree to which demand for the products involved is price sensitive and exchange rate movements are passed through into prices. For example, Japanese exports of video cassette recorders—VCR's—may be more income elastic than price elastic. Other Japanese exports may be both price elastic and subject to passthrough.

Economic models suggest that U.S. exports to Japan are not very price sensitive. A 10 percent reduction in U.S. export prices might yield only a volume increase of only 5 percent, resulting in lower net dollar earnings.

Japanese exports to the United States appear to be more price sensitive, but the models suggest that higher Japanese prices, while lowering the volume of exports, will increase revenues almost enough to compensate for volume decreases.

These effects may be especially pernicious in competition for third country sales. Unconfirmed reports indicate U.S. exporters of telecommunications equipment and heating and air-conditioning equipment may have lost as much as $2 billion in contracts over the last year due to yen depreciation.

Caterpillar Tractor Co. calculates that because of the yen depreciation, its Japanese competitor has a $20,000 price advantage on a $100,000 tractor. Caterpillar and other American manufacturers that rely heavily on foreign markets are losing ground to Japanese competitors—not because U.S. firms are less productive—but because the yen depreciation gives their Japanese competitors a pricing edge.

In conclusion, I would like to emphasize two basic points:

First, our analysis suggests that while variations in the U.S. deficit may be associated with exchange rate changes and business cycle fluctuations, the actual level and the chronic character of the deficit reflect structural difficulties in our trade relationship with Japan.

In our view, the chronic U.S. trade imbalance is best addressed by dealing with the fundamental problem of market access for U.S. exports and investment in Japan. The value of the yen vis-a-vis the dollar, while it has an important role in redressing the imbalance, is only part of the larger problem of eliminating Japanese barriers.

Secretary Baldrige recently reiterated our position that continued access to the U.S. market for Japanese exports is contingent upon specific actions to open the Japanese market. This liberalization should include Japan's capital market so that the yen becomes increasingly internationalized.

Liberalization of the Japanese financial system parallels our efforts to open the entire Japanese economy to foreign participation. We support such liberalization even though it may in the short run slow down yen appreciation due to further capital outflows. In the longer term, as the yen becomes a more widely held reserve currency, its value may be enhanced. We also continue to believe that liberalization of Japan's markets for goods and services, especially in the high-technology area, is fundamental in redressing our trade imbalance.

Second, we cannot ignore the fact that the dollar has appreciated roughly as much against many major currencies as against the yen. To this extent we are experiencing a dollar problem rather than simply a yen problem. The overvalued dollar raises numerous questions about the overall competitiveness of U.S. manufactured exports.

We are currently witnessing a decline in U.S. manufactures exports worldwide which may well continue into 1983. At an annual rate through October, the United States had a manufactures trade deficit of $10.9 billion (c.i.f.). United States manufactures exports were $118.8 billion, down 8.1 percent from last year's $129.2 billion. Much of this decline is attributable to the appreciation of the dollar vis-a-vis major currencies, including—but not limited to—the yen.

The dollar's rise is not justified on the basis of relative inflation rates. This has placed U.S. exports at an unfair price disadvantage in world markets and threatened continued business support for the free trade system.

Thus, to the extent we are concerned about factors which influence U.S. competitiveness, we must consider it a dollar problem, rather than a yen problem.

Unless and until we can demonstrate that the current yen/dollar disparity results from specifications of the Government of Japan—and at this point we cannot—it must be considered an issue of U.S. global competitiveness.

[The prepared statements follow:]

STATEMENT OF EUGENE K. LAWSON, DEPUTY ASSISTANT SECRETARY FOR EAST ASIA AND PACIFIC

Mr. Chairman and members of the Subcommittee:

The yen-dollar exchange rate is the focus of growing attention in discussions of U.S.-Japan economic relations.

Our current trade frictions with Japan are in many ways like those of 1971-72 and 1977-78. They appear to repeat a historical pattern in which severe U.S. merchandise trade imbalances with Japan often coincide with dramatic exchange rate movements, and business cycle fluctuations.

At the same time, the present problem is distinctly unlike previous episodes. In this instance, the merchandise trade imbalance has not lead to adjustment through yen appreciation. Instead, the yen has continued to depreciate. Moreover, the weaker yen, by making Japanese exports to the United States more price competitive and U.S. exports to Japan less so, may have made a bad situation worse. This factor drawns attention to exchange rate effects on trade balances and relative competitiveness.

In order to understand this problem, we need to ask at least five fundamental questions:

First, Is the yen undervalued? That is, is there a fundamental misalignment of the two currencies?

Second, If so, what are the underlying causes of this disparity? And especially,

Is there evidence of official intervention to defeat classic equilibrating mechanisms?

Moving from causes to effect, we can ask:

What if any, is the relationship between an undervalued yen and the U.S. deficit on bilateral trade? And

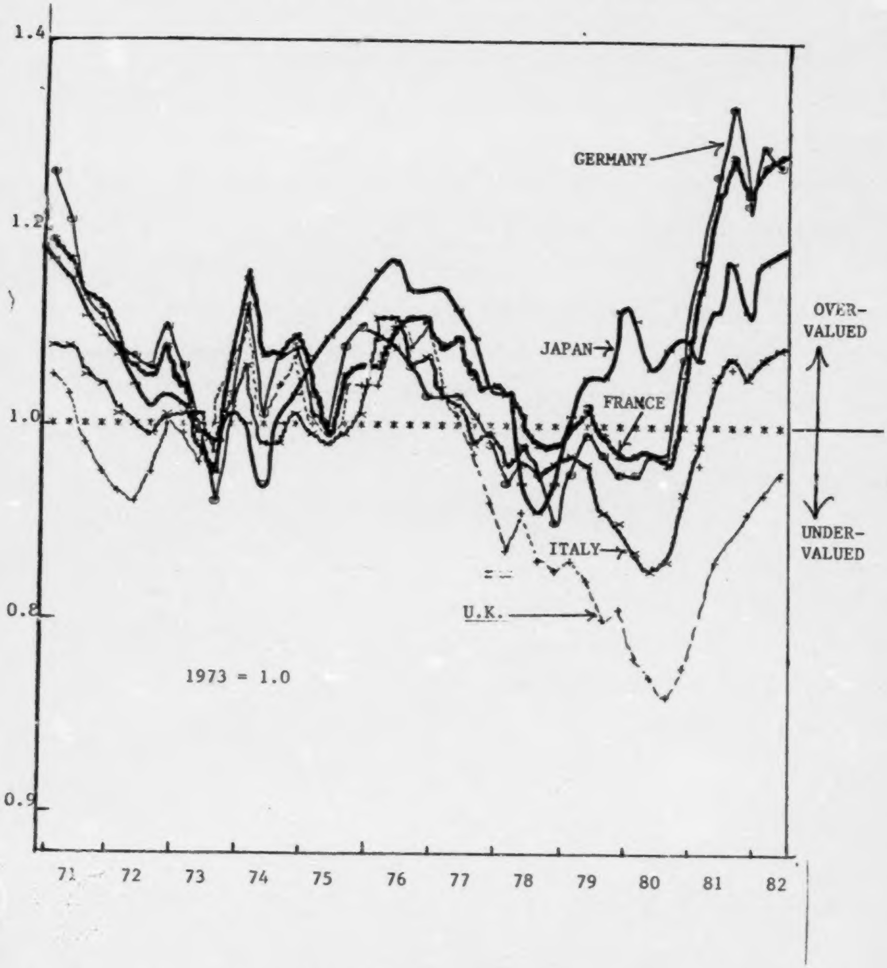
Finally, What has been and is likely to be the effect on U.S. trade competitiveness in Japan, in the U.S., and in third country markets?

Today, I would like to summarize for the Subcommittee my views on these questions. I will conclude by placing the yen-dollar exchange rate issue in the context of our efforts to liberalize the Japanese market for goods, services, and capital and to enhance overall U.S. export competitiveness.

Is the Yen Undervalued

Undervaluation is a difficult concept to establish. The chart which accompanies my submission approaches the question from the direction of an overvalued dollar.

OVER-VALUATION OF THE DOLLAR AGAINST LEADING CURRENCIES



This chart depicts indices of overvaluation for major currencies. Each index is calculated is the ratio of the actual exchange rate to the rate that would be necessary to maintain the level of relative price competitiveness that existed in 1973. Thus, an index of 1.2 means that the current bilateral exchange rate overvalues the dollar by 20 percent and that a depreciation of the dollar in terms of the foreign currency would be necessary to restore the relative level of price competitiveness existing in 1973. Relative price competitiveness is measured in terms of export prices.

All data is from the International Financial Statistics published by the IMF.

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In this exhibit, overvaluation is measured as the ratio of the actual exchange rate to the hypothetical exchange rate which would maintain the same level of price competitiveness as existed in 1973. Thus, when the index reaches 1.2, it indicates that the dollar is overvalued by approximately 20 percent relative to the other currency.

Using this methodology, IMF Data through the second quarter of 1982 (the latest available), suggest that the yen is undervalued (or the dollar overvalued) by approximately 20%. However, readings for other currencies show the mark undervalued by 30% and the franc by approximately 28%.

Thus, it appears that, if the yen is undervalued, there is no reason to assume that it is *more* undervalued than other competitor currencies. On the contrary, two other major currencies appear to be more out of line than the yen.

Causes

The underlying causes of currency misalignment are complex. In the case of the yen, the recent depreciation parallels the appreciation of the dollar vis-a-vis all major currencies which has resulted from higher U.S. real interest rates and the preference of investors for U.S. assets during periods of political and financial uncertainty. In the case of Japan, it appears that a lower current account surplus than expected has also been depressing the yen. But the major factor appears to be the overshadowing of the current account surplus by Japan's capital account deficit. Capital flows in and out of Japan have increased dramatically in recent years due in part to significant liberalization, but the outflows have been much greater than the inflows. With the exception of 1980, the Japanese capital account has been in substantial deficit since 1978 (see attached table).

Specifically, it should be emphasized that there is no evidence that the government of Japan has intervened to maintain an artifically depressed yen as a stimulus to export sales -- or for any other policy consideration.

On the contrary, the Government of Japan has tried -- unsuccessfully -- to support the yen. Japanese authorities have intervened vigorously in exchange markets this year in support of the yen.

Impact on the Bilateral Deficit

As a general observation, it is obvious that a weaker yen--by making Japanese exports to the United States more price competitive and U.S. exports to Japan less so--tends to worsen our bilateral trade deficit with Japan, which last year was $16 billion and this year will be about $18 billion.

Beyond this, it is difficult to determine with any precision exactly how much of the current imbalance can be attributed to exchange rate changes. The answer depends in part on the time-period in question; the degree of shift actually experienced or hypothesized in the rate, and the model, assumptions, and methodology used to generate statistical answers. Generally, our research indicates that yen-dollar exchange rate movements have not had a major impact on the bilateral imbalance.

Over the longer-term, we have found that from 1974-77 the deficit grew even while the yen was appreciating. Since late 1978, however, growth in U.S. imports from Japan -- and the bilateral deficit -- have coincided with depreciation of the yen. Depreciation of the yen appears to have had little effect on U.S. exports to Japan. This may be accounted for by the fact that U.S. exports to Japan are composed mainly of food item which are relatively unresponsive to higher relative prices.

In general, the effect of yen depreciation is greater on U.S. imports from Japan than on U.S. exports to Japan.

In terms of the more recent undervaluation of the yen, our research indicates that U.S.-Japan trade in 1981 may not have been responsive to yen/dollar movements. A simulation of a 20 percent appreciation of the yen in 1981 did result in increased U.S. exports to Japan but the bilateral trade deficit was only reduced by about $1 billion. Even if the simulation assumptions were changed, indications are that yen appreciation in the short term cannot be expected to reduce the bilateral deficit by more than $2-3 dollars.

To explore this point a little further we did some very quick analysis using a simple model to explain changes in the bilateral trade balance between Japan and the United States. What we found was that differences in rates of economic growth -- business cycles if you will -- explain more than half of the variation in the bilateral deficit over the last ten years. Changes in relative price competitiveness have almost no explanatory power.

Impact on U.S. Competitiveness

The extent to which exchange rate movements can effect the relative price competitiveness of specific U.S. industries will depend on the degree to which demand for the products involved is price sensitive and exchange rate movements are passed through into prices. For example: Japanese exports of videorecorders (VCRs) may be more income-elastic than price-elastic; automobile exports may be price-elastic but yen appreciation may not be passed through in the short run, particularly as long as there are export restraints; other Japanese exports may be both price-elastic and subject to passthrough with a consequent reduction in volume.

Economic models suggest that U.S. exports to Japan are not very price sensitive. A ten percent reduction in U.S. export prices might yield only a volume increase of only five percent, resulting in lower net dollar earnings.

Japanese exports to the United States appear to be more price sensitive, but the models suggest that higher Japanese prices while lowering the volume of exports will increase revenues almost enough to compensate for volume decreases.

These effects may be especially pernicious in competition for third country sales. Unconfirmed reports indicate U.S. exporters of telecommunications equipment and heating and air-conditioning equipment may have lost as much as $2 billion in contracts over the last year due to yen depreciation. Caterpillar Tractor Co. calculates that, because of the depreciation of the yen, its Japanese competitor has a $20,000 price advantage on a $100,000 tractor. Caterpillar and other American manufacturers that rely heavily on foreign markets are losing ground to Japanese competitors -- not because U.S. firms are less productive -- but because the depreciation of the yen gives their Japanese competitors a pricing edge.

To test these effects, Commerce has the analyzed price and exchange rate movements of the yen and of U.S. and Japanese export prices. The conclusion of that review is that the current yen/dollar exchange rate has significantly decreased the price competitiveness of U.S. products vis-a-vis Japanese products. Using an average for 1973 as a base year of comparsion, the yen would need to be approximately 20 percent higher than today in order to have the same level of price competitiveness when export prices of the United States and Japan are compared.

I would like to emphasize to basic points:

First, Our analysis suggest that while variations in the U.S. deficit may be associated with exchange rate changes and business cycle fluctuations, the actual level and the chronic character of the deficit reflect structual difficulties in our trade relationship with Japan. In our view, the chronic U.S. trade imbalance is best addressed by dealing with the fundamental problem of market access for U.S. exports and investment in Japan. The value of the yen vis-a-vis the dollar, while it has an important role in redressing the imbalance, is only part of the larger problem of eliminating

Japanese barriers. Secretary Baldrige recently reiterated our position that continued access to the U.S. market for Japanese exports is contingent upon specific actions to open the Japanese market. This liberalization should include Japan's capital market so that the yen becomes increasingly internationalized.

Liberalization of the Japanese financial system parallels our efforts to open the entire Japanese economy to foreign participation. We support such liberalization even though it may in the short run slow down yen appreciation due to further capital outflows. (In the longer term, as the yen becomes a more widely-held reserve currency, its value may be enhanced.) We also continue to believe that liberalization of Japan's markets for goods and services, especially in the high-technology area, is fundamental in redressing our trade imbalance.

Second, we cannot ignore the fact that the dollar has appreciated roughly as much against many major currencies as against the yen. To this extent we are experiencing a dollar problem rather than simply a yen problem. The overvalued dollar raises numerous questions about the overall competitiveness of U.S. manufactured exports.

We are currently witnessing a decline in U.S. manufactures exports worldwide which may well continue into 1983. At an annual rate through October, the United States had a manufactures trade deficit of $10.9 billion (c.i.f.). U.S. manufactures exports were $118.8 billion, down 8.1% from last year's $129.2 billion. Much of this decline is attributable to the appreciation of the dollar vis-a-vis major currencies, including -- but not limited to -- the yen.

The dollar's rise is not justified on the basis of relative inflation rates. This has placed U.S. exporters at an unfair price disadvantage in world markets and threatened continued business support for the free trade system.

Thus, to the extent we are concerned about factors which influence U.S. competitiveness, we must consider it a dollar problem, rather than a yen problem. Unless and until we can demonstrate that the current yen/dollar dispartiy results from specific actions of the government of Japan -- and at this point we cannot -- it must be considered an issue of U.S. global competitiveness.

Wang No. 0626N

The Yen-Dollar Exchange Rate and Japanese Current and Capital Accounts (in billions of U.S. dollars)

	Yen/Dollar Rate	Japanese Current Account	Japanese Capital Accounts
1976	300	$ 3.7	$ 0.9
1977	270	$ 10.9	$(3.8)
1978	210	$ 16.5	$(10.9)
1979	220	$(8.8)	$(10.2)
1980	230	$(10.7)	$ 5.5
1981	220	$ 4.7	$(7.4)
1982 I	235	$(0.9)	$(4.9)
II	245	$ 2.5	$(7.2)
III	260	$ 2.8	-

Note: Exchange rates are rounded to nearest 10 yen and represent average rate for year or quarter indicated (source: *International Financial Statistics*, IMF). Source of balance of payments data is *Balance of Payments Monthly*, The Bank of Japan.

U.S.-Japan Bilateral Trade and Trade Deficit (in billions of U.S. dollars)

	U.S. Exports	U.S. Imports	Balance
1976	10.2	15.5	-5.4
1977	10.5	18.6	-8.0
1978	12.9	24.5	-11.6
1979	17.6	26.3	-8.7
1980	20.8	30.7	-9.9
1981	21.8	37.7	-15.8
1982 I	5.4	10.0	-4.6
II	5.1	9.7	-4.6
III	5.1	9.6	-4.5

Note: Census basis; numbers may not add due to rounding.

Chairman GIBBONS. Thank you.

Ms. Constable.

STATEMENT OF ELINOR G. CONSTABLE, DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL FINANCE AND DEVELOPMENT, BUREAU OF ECONOMIC AND BUSINESS AFFAIRS, U.S. DEPARTMENT OF STATE

Ms. CONSTABLE. Mr. Chairman, I have prepared a rather brief statement for this hearing. I hope it will be included in the record.

Chairman GIBBONS. Certainly.

Ms. CONSTABLE. My comments echo a number of the points which have just been made by the two previous witnesses. With your permission, I will briefly summarize the main points in order to save time.

Mr. Chairman, I am very happy to be here today to discuss the yen-dollar relationship.

Chairman GIBBONS. Could you get closer to the microphone, ma'am? We are having a hard time hearing you.

Ms. CONSTABLE. Can you hear me now?

Chairman GIBBONS. If the Japanese would sell us a better microphone.

Ms. CONSTABLE. My first point is simply that exchange rates are key and often controversial prices determined—and perhaps I should emphasize controversial—determined through the complex interactions of both economic and noneconomic factors. The yen-dollar exchange rate is a case in point. In my comments, I address three interrelated questions.

The first, of course, is the question of whether the yen is undervalued vis-a-vis the dollar. There are obviously many in the United States who argue that it is, and that the undervalued yen gives the Japanese an unfair trade advantage in the United States and in third-country markets.

We have just heard a number of comments on that point. The problem, though, is that the determination of the right value for a currency at a given time is an analytically slippery concept. I do not plan to explore it in detail in my testimony.

The second question, of course, which everyone has commented upon, is whether the Government of Japan is orchestrating a variety of policies to keep the yen down; and here the answer, in our view, is clearly that they are not.

If you look at Japanese exchange rate policy over a period of time, you can conclude that the Japanese Government has not sought to weaken the yen except—and now I am not talking about the current period—except in periods when it was climbing rapidly in value.

You might characterize exchange rate policy as leaning against the wind. Japanese intervention has not, in fact, depressed the value of the yen over a sustained period, although it may have moderated the speed of its movements from time to time.

The third question which I address in my testimony is, I think, the key question: Where does the exchange rate issue fit in the broader context of the United States-Japan economic and political relationship?

Clearly, the weak yen combined with Japanese penetration of U.S. markets has generated protectionist pressures. It is equally clear a deterioration of United States-Japan economic relations would have undesirable policy consequences.

Seen in this larger perspective, the exchange rate remains important and we monitor carefully exchange rate movements and Japanese actions which affect the value of the yen, but we have other objectives as well, including the further liberalization of Japanese capital markets.

More generally, we continue to work with the Japanese in an effort to put the bilateral trade financial relationship on a more symmetrical footing. Accordingly, in our view, a single-minded focus on the yen-dollar exchange rate would not be productive.

Those are my principal points, Mr. Chairman. Thank you.

[The prepared statement follows:]

STATEMENT OF ELINOR G. CONSTABLE, DEPUTY ASSISTANT SECRETARY OF STATE FOR INTERNATIONAL FINANCE AND DEVELOPMENT, BUREAU OF ECONOMIC AND BUSINESS AFFAIRS

Mr. Chairman, I am pleased to be with you today to discuss the yen/dollar relationship. Exchange rates—The value of given currencies in terms of others—are key and often controversial prices determined through the complex interactions of both economic and non-economic factors. The yen/dollar exchange rate is a case in point and gives rise to three interrelated questions:

First, is the yen undervalued vis a vis the dollar? Many in the U.S. argue that it is and that the undervalued yen gives the Japanese an unfair trade advantage in the U.S. and third-country markets. The determination of the "right" value for a currency at a given time is an analytically slippery concept, which I do not plan to explore in detail today.

Second, is the Government of Japan orchestrating a variety of policies to keep the yen down? Here, the answer is no.

Third, where does the exchange rate issue fit in the broader context of the U.S./Japan economic and political relationship? Clearly, the weak yen combined with Japanese penetration of important U.S. markets has stimulated protectionist pressures. It is equally clear that a deterioration of the U.S./Japan economic relationship would have undesirable foreign policy consequences. Seen in this larger perspective the exchange rate remains important—and we monitor carefully exchange rate movements and Japanese actions which affect the value of the yen—but we have other objectives as well, including the further liberalization of Japanese capital markets. More generally, we continue to work with the Japanese in an effort to put the bilateral trade/financial relationship on a more symmetrical footing. Accordingly, a single-minded focus on the yen/dollar exchange rate would not be produtive.

JAPANESE EXCHANGE RATE MANAGEMENT: POLICY AND TOOLS

The Government of Japan, as do most governments, tries to smooth erratic fluctuations in the exchange rate of its currency, consistent with its international obligations, but does not appear to resist the market in terms of secular trends in the yen's value. The announced aim of Japanese exchange rate policy is to limit wide and destabilizing fluctuations. The tools available to the Government of Japan include direct exchange market intervention and currency/investment controls, including "widow guidance" or informal advice from the Central Bank. Other less important devices to influence the exchange rate include changes in financial policies and administrative controls over imports and exports, e.g., export restraint or raw material purchases to reduce trade surpluses. Since the enactment of the Foreign Exchange and Trade Law of 1980, which initiated a process of liberalized capital transactions, the use of currency/investment controls has played a smaller role. Central Bank guidance, however, remains available and is a major policy lever.

The question raised by some is whether the Government of Japan has marshalled its array of policy instruments in a concerted attempt to keep the yen undervalued. The most frequently cited evidence that the Japanese are manipulating their currency is the existence and use of capital controls. These, however, were significantly liberalized by 1980, as we had been urging. Remaining controls are largely designed to restrict outflows, and it is generally believed that they have helped moderate the yen's decline against the dollar.

Critics also argue that Japan's reserve movements suggest that the GOJ has put downward pressure on the yen over the last decade. However, since 1978 Japan experienced a net decline in reserves, indicating that, on balance, official intervention has supported the yen exchange rate, in other words prevented its depreciation.

In fact, Japanese exchange rate policy has always been aimed at moderating movements of the yen. Following the first oil shock, as the yen came under pressure, the Japanese Government intervened in support of the yen and encouraged capital inflows. As the yen appreciated sharply in 1977-78, the Japanese relaxed currency controls to promote capital outflows and intervened heavily to slow the yen's appreciation. In 1979 and 1980 they relaxed investment restrictions further to encourage capital inflows to stabilize the yen after the second oil shock. These measures worked in 1980 but as real interest rates in the U.S. increased capital flowed out of Japan.

The available evidence suggest two things:

(1) Japan has not sought to weaken the yen except in periods when it was climbing rapidly in value—we would characterize Japanese exchange rate policy as "leaning against the wind";

(2) that Japanese intervention policy has not, in fact, depressed the value of the yen over a sustained period, although it may have moderated the speed of its movements.

For instance, the Japanese took in some $20 billion to slow the yen's climb in 1977-78, yet it rose 50 percent (nominal terms) against the dollar. It took the second oil shock to bring the yen down. Likewise, the Government of Japan's recent, strenuous efforts to slow the yen's decline against the dollar have been only partially successful.

A recent IMF study suggest that the long-run value of the yen is determined by relative price levels and changes in trend of Japan's current account balance relative to its major trading partners. In the short run, there are a variety of factors, including relative interest rates and perceptions of international political stability, which affect the yen's value.The policy changes normally urged on the Japanese—more open markets and further reductions in capital and currency controls, laudable as these goals are—would probably depress rather than strengthen the yen, at least in the short-term. As noted above, most remaining controls are on capital outflows. Thus, "more open" markets would lead to a depreciation of the yen. New or tighter controls on outflows might boost the yen, but would conflict with the U.S. objective of promoting more liberal capital markets in Japan.

TRADE

While a substantial appreciation of the yen would contribute to easing trade frictions with Japan, it would not address the more basic issues in U.S.-Japan trade relations. There is a widespread perception that Japanese markets are less open to U.S. and other foreign firms than U.S. and international markets are to Japanese firms. U.S. firms seeking to enter the Japanese market have often been frustrated by formal and informal Japanese procedures, policies and regulations that act as trade barriers.

The Japanese Government is aware of these problems and has sought to address them in two packages of trade liberalization measures announced this year. While these packages have resulted in some progress in the areas of standards and customs procedures, we believe much more needs to be done to open the Japanese market. A U.S. team, headed by USTR, has been meeting with the Japanese on a regular basis to follow-up implementation of the announced measures and to seek further opening of the Japanese market. We have also begun negotiations with the Japanese aimed at eliminating quotas on important U.S. agricultural exports such as beef and citrus. And we are working on an understanding that would assure both countries' markets for trade in high technology products are as open as possible.

We hope these efforts will lead to a significant opening of Japanese markets in the near term, with a consequent expansion in bilateral trade flows.

Mr. Chairman, trade is a critical element in our overall bilateral relationship with Japan. We need to achieve a balance of advantage in trade with Japan, which will permit a continued, healthy expansion of trade to the benefit of consumers and producers in both countries. In addition, trade issues need to be managed carefully to minimize negative spill-over into other aspects of U.S.-Japan relations. Accordingly, the yen/dollar exchange rate and other factors which affect our economic position vis a vis Japan will continue to receive our close and critical attention.

Chairman GIBBONS. We have a statement, too, from Mr. Sprinkel we will put in the record at this point.

[The prepared statement follows:]

STATEMENT OF HON. BERYL W. SPRINKEL, UNDER SECRETARY FOR MONETARY AFFAIRS, U.S. DEPARTMENT OF THE TREASURY

THE JAPANESE YEN EXCHANGE RATE

Mr. Chairman, two months ago I had the pleasure of testifying before your Subcommittee on the relationship between the dollar and the Japanese yen. I appreciate this opportunity to supplement my remarks on this important topic.

In my testimony of October 1, I observed that:

Developments in the yen/dollar exchange rate are not unique. In recent years, the dollar has appreciated against all major currencies, and in some cases by larger amounts than against the yen.

In addition to generalized dollar strength, there are factors specific to Japan which have contributed to the yen's depreciation this year: weaker Japanese external performance than previously anticipated, including declining Japanese export volume—due partly to Japanese export restraints and protectionist pressures which lower market expectations of future Japanese export earnings—and large net capital outflows from Japan, reflecting a Japanese propensity to export capital in view of Japan's high domestic savings rate.

Japan has made substantial progress in internationalizing its financial system in recent years as shown by the sizeable growth of capital flows in and out of Japan. A consequence of greater foreign access to Japan's capital markets, at least in the short term, is downward pressure on the yen and this has also been a factor in the yens weakness.

We have looked at the situation closely and found no evidence to support allegations that the Japanese authorities are manipulating markets to weaken the yen. A review of Japan's macroeconomic policy objectives, foreign exchange market intervention, and efforts last spring to raise short-term interest rates (and more recently to limit declines in these rates) suggests that the Japanese authorities seek a stronger yen.

Over the long term, changes in exchange rates can be expected to reflect relative price movements. But purchasing power parity measures, which some cite as demonstrating the existence of an undervalued yen, are not a useful guide to the "correctness" of exchange rates. At any particular time, many factors can—and should—influence exchange rates in the near term.

I should also note the additional point that if the yen were persistently undervalued, one would expect to see a large-scale build-up in Japanese foreign exchange reserves and a persistently large Japanese current account surplus. Neither has occurred. Over the last decade, Japan's reserve increases have been, on average, no greater than reserve increases in other industrial countries. The current level of Japanese reserves is equivalent to the value of about 2 months of Japanese imports, not an unusually high reserve level. Japan's cumulative current account surplus from 1973–1981 amounted to roughly 0.15 percent of GNP, not a huge magnitude in absolute terms or relative to the experience of other countries.

There have been two recent developments which I would like to bring to your attention. First, in late October, the Administration held a Cabinet Council meeting on the yen question, and Cabinet officials subsequently met with representatives of the U.S. business community to discuss the issue. I will comment on some of the policy approaches discussed in these and other meetings in a moment. Second, the yen has appreciated sharply from its October lows against the dollar. As of last Friday, the yen had risen to around Y250, a 10 percent appreciation. It has also strengthened against European currencies. One apparent factor behind the yen's recent strength has been resumed foreign investment in the Japanese bond and stock markets.

Various comments on the yen exchange rate indicate that some feel the yen/dollar relationship is the central problem in U.S.-Japanese trade relations, and that the United States should immediately initiate action against Japan on this front. I believe that this is off the mark and would like to comment on the desirable policy response and the attitude we should adopt regarding the yen/dollar relationship.

First, we should continue to press Japan to liberalize and internationalize its financial system, even though liberalization could tend to weaken the yen in the short term. A liberal environment for international investment flows is in our interest, in Japan's and that of the world at large. The United States should not urge Japan to impose controls on capital outflows in an effort to strengthen the yen.

Second, we should not press Japan to reorient its fiscal and monetary policies toward relaxing efforts to control budget deficits and raising Japanese interest rates. The Japanese budget deficit is presently about 5½ percent of GNP. The Japanese authorities want to cut fiscal deficits and the growth in government expenditures. These are the same fiscal objectives this administration is pursuing. I would not accept contrary advice for the United States.

Third, we should not argue that Japan should have an exchange rate target or intervene more in the markets in an effort to strengthen the yen. The foreign exchange markets are too big to direct, control or manipulate in any lasting sense, and we believe that the judgment of the marketplace about exchange rates is superior to that of government officials.

Fourth, we should strongly oppose suggestions that the U.S. impose a variable import duty on U.S. imports from Japan or other nations which some allege to have "undervalued" currencies. Such action would be flatly protectionist and would represent not only a serious violation of the GATT principle of most-favored-nation treatment, but a serious departure from the historic U.S. commitment to free trade.

Let me conclude by commenting on the notion that the yen's weakness is the key issue in U.S.-Japanese economic relations and a primary cause of rising global protectionist pressures. Periods of low economic growth and high unemployment frequently give rise to protectionist pressures. The current environment is no different, and exchange rate developments have not eased the situation. But the main problem faced in U.S.-Japanese economic relations is not exchange rates but the plethora of informal and formal Japanese barriers to foreign imports. The closed character of the Japanese market towards foreign imports stands in sharp contrast to the openness of the U.S. to foreign participation. I have no doubt about the ability of the United States to compete effectively under open and mutually respected trading rules.

We are asking that Japan open its markets fully to foreign participation in order to assume its proper responsibility for maintaining the global free trade system. Japan's continuing reluctance to do so is the real danger posed by U.S.-Japanese economic relations to the world trading system. It is this danger that the Reagan Administration will continue to address in its negotiations with the Government of Japan.

Chairman GIBBONS. Of course, the testimony we hear this afternoon is considerably different than the testimony we heard this morning. That was the purpose of having these hearings, to try to highlight the differences. Apparently the administration feels, at least the Council of Economic Advisers feels, there is nothing wrong and nothing we can do about it or should do about it.

Am I summarizing your statement correctly?

Mr. NISKANEN. Mr. Chairman, I am not in a position to speak for the administration.

Chairman GIBBONS. You are one member of the Council.

Mr. NISKANEN. My testimony was really restricted to an evaluation of the available evidence on some of these charges that have been made.

Chairman GIBBONS. Yes. How much confidence do we have in the evidence? I have lived around here long enough to realize I am probably not as skeptical as I ought to be. How reliable is this evidence we have? We don't collect evidence; somebody else collects it.

Mr. NISKANEN. Mr. Chairman, I think there is no serious basis for questioning the evidence itself. There is a reasonable basis for different interpretations of the evidence. Any calculation of a purchasing power parity relationship is based upon somewhat arbitrary assumptions.

I am pleased that the Commerce Department estimates, which use a different base period as well as different deflators than those which the Treasury and CEA estimates were based, comes up with basically the same conclusion concerning the relative depreciation of the same currencies.

But there is no nonarbitrary set of conditions under which to evaluate whether the yen is undervalued by a specific amount.

For example, using a base period of 1970, prior to the floating exchange rate period, the yen would now appear to be substantially overvalued, not undervalued.

So there is a certain arbitrariness in interpreting the evidence. I don't think there is any reason to question the evidence itself.

On the question of the magnitude of Japanese interventions in the exchange market, as I said, the data are not publicly available. One can infer the magnitude of their interventions, however, from a change in their reserve position plus the interest that they would have earned on their absolute level of reserves.

Chairman **Gibbons**. How do we know their reserve position is accurately stated? Maybe it is to their advantage to misstate their reserve position. Maybe they could have been doing it systematically over a long period of time.

Mr. **Niskanen**. That may be, Mr. Chairman. But if that is the case, no one has picked it up.

Chairman **Gibbons**. Picked it up?

Mr. **Niskanen**. To my knowledge, there have been no allegations to that effect.

Chairman **Gibbons**. How long did it take us to pick up something as simple as this con job on the bicycle and motorcycle racing? They have been doing that ever since World War II. It took some enterprising law firm here in D.C. to find that one out. I have never heard about it. I have sat on this committee for 15 years. Nobody in our government has ever told me about that con job.

In fact, the Japanese first—if I can believe the people who called on me about it—denied it ever existed. Now it appears to be about a billion-dollar con job of subsidies going on sub rosa.

I have lost all confidence in these figures. They could have misstated their reserves. It has been to their advantage for years to have an undervalued yen, according to the witnesses of this morning.

Mr. **Niskanen**. I seriously question the conclusion that several witnesses have made that the yen has been generally undervalued. That assertion is not consistent with the other kind of evidence that we have on their balance of payments and reserve position.

Chairman **Gibbons**. I hate to raise things about citrus, but I talked to the Prime Minister of Japan, Mr. Fukuda, about the con job of how they financed the Liberal Democratic Party out of the orange quota.

There was no doubt that he understood exactly what I was saying. He didn't blink an eye. I talked to the Japan Tobacco & Salt Corp. about how they were conning everybody on that years ago. They didn't blink an eye.

You know, I just lost all confidence in these figures. I have been through their factories. There is nothing mysterious about what they do.

Sure, they are good. They are getting an educational system; but we look like we are in a position where there is no way to solve the problem. I am beginning to lose confidence in the validity of the statistics that we cite and rely upon.

Mr. NISKANEN. Mr. Chairman, I think their statistics are going to be subject to error, too. I think in general, however, one is likely to make much more serious policy errors by ignoring the available evidence than by paying attention to them on a careful basis.

Chairman GIBBONS. You have predicted, I have watched the statement in the paper, the administration predicted the balance of trade with Japan, around the world, is going to continue to expand. None of these things have any end to them. I don't know what we are going to do here in this Congress if we have a merchandise trade deficit of $100 billion, as one witness propounded this morning.

There is no way to contain that kind of deficit in our economy. What are we going to do?

Mr. NISKANEN. A current account deficit will mean that we will be borrowing from other countries during that period, in a period in which we will be running a very high government deficit; that is an additional outcome in order to alleviate interest rate pressures in the United States.

We would have much more severe interest consequences in the United States next year and in the following years if we did not have such a current account deficit.

Chairman GIBBONS. Go over that again for me, please.

Mr. NISKANEN. A current account deficit in effect means that we are borrowing from abroad. In a period of time in which the government expects to be borrowing a great deal, money flowing in from abroad will alleviate the interest rate pressures of that borrowing. If we took actions which would directly reduce that current account deficit, or maintain a current account surplus, the interest rate consequences of the government borrowing would be much more severe.

I think it is very important at this same time to reduce the magnitude of this government borrowing, hopefully through spending controls and economic growth, but that government borrowing will be a fact of life which we are going to have to live with, and one way to alleviate the interest consequences of that government borrowing would be the expected current account deficit next year.

Chairman GIBBONS. I see what you are driving at, but I want to stop and think my way through that one again.

You have painted a picture for which there is no recovery, just about.

Mr. NISKANEN. I don't mean to suggest——

Chairman GIBBONS. Why does the dollar get stronger and stronger and stronger if your picture is true?

It looks like to me that we have entered into, as they used to say in the aeronautical vernacular, a flat spin, and there is no way out of this thing.

We have lost all lift and we are going right in. Yet the dollar gets stronger and stronger and stronger versus all these currencies.

Mr. NISKANEN. Mr. Chairman, I think that looking at the exchange rates in the traditional way, this summer would have led to a big puzzle because there was a large drop in U.S. interest rates during this period of time, and the dollar continued to strengthen.

The accepted explanation of that phenomenon is that there has been a great deal of flight currency, a flow of saving into the United States basically as a consequence of political anxiety in a number of countries around the world. That, I think, is not something that would continue.

I am a most reluctant forecaster under any circumstances, and particularly for the exchange rate.

For all of that, I expect that the strength of the dollar, as revealed on November 8, just several weeks ago, is likely to be the peak of the dollar.

The dollar has declined relative to all other currencies about 2 to 3 percent since that time, and I believe about 9 percent relative to the yen.

All too often I think that we tend to get exercised about conditions just about the time that the conditions are reversed, and sometimes even later, and I would caution against measures that are taken based upon a concern about the presumed weakness of the yen or the strength of the dollar unless it is quite clear those conditions are going to continue rather than reverse themselves.

Chairman GIBBONS. Mr. Pease?

Mr. PEASE. Thank you, Mr. Chairman. I think this testimony has been interesting also, as this morning's testimony was.

My interest in this afternoon's testimony is as much as anything because of its contrast to what we heard this morning. I think we up here are looking for some consistent threat, and yet the testimony this afternoon seems in large part to contradict what was said this morning.

Is it the administration's policy that the yen is not undervalued?

Mr. NISKANEN. The yen does appear to be somewhat undervalued at the moment relative to its longer term relationships with the dollar. It looks like it has appreciated relative to most other currencies.

Now, even the conclusion that the yen appears to be temporarily undervalued relative to the dollar is subject to some arbitrariness, based upon the base periods and deflators and so forth that one uses to evaluate these purchasing-power-parity comparisons, but I think that anybody looking at the evidence would come to much the same conclusion, in terms of both direction and magnitude.

The Commerce testimony used a rather different basis for the calculations, but comes to the same relative conclusion on these matters.

Mr. PEASE. What you are saying is at the moment the yen is under-valued but not as much as the franc or the mark against the American dollar, is that right?

Mr. NISKANEN. That is right.

Mr. PEASE. We heard this morning private witnesses say that they thought the exchange rate for the yen ought to be somewhere between 180 and 200 to the dollar. What would you put the figure at?

Mr. NISKANEN. The calculations which we made suggest that the purchasing power parity natural rate at the moment would be around 220. The allegations or the assertions that have been made that the appropriate exchange rate is in the 180 to 200 range I think are not consistent with what happened at a time when the yen was that strong.

In the year or two following that very strong yen, the Japanese had a big current account deficit, and that is the best indication that the yen at that time was unusually strong rather than at its natural rate.

Mr. **Pease**. Does the administration take the position that the Japanese Government ought to take any action to strengthen the yen against the dollar?

Mr. **Niskanen**. The Japanese Government, in fact, has been intervening heavily to strengthen the yen. We are reluctant to advise other governments about what they ought to do in their own interests.

The facts are that they have been putting a lot of money into strengthening the yen, for the most part not being sufficient, however, to counter the other forces that are operating.

Mr. **Pease**. The witnesses this morning said that they wouldn't be at all reluctant to advise the Japanese on what to do, but not in the Japanese interests solely but in our interests primarily, and secondarily, in the Japanese interests, sort of enlightened self-interest. You are saying that the administration policy is different from what we were urged to do this morning?

Mr. **Niskanen**. I think that we cannot operate in the world on a beggar-your-neighbor basis. Several of the suggestions that have been made are strongly inconsistent with world trading rules that have been worked out painfully over several decades.

Those rules are under severe pressure at best. These GATT mechanisms that are fragile, and I would at least be very cautious about taking actions which would look to be a strong violation of those rules.

Mr. **Pease**. You said in your testimony, in response to your own rhetorical question about whether the Japanese policies have weakened the yen, that there are mixed results, mixed actions. Some tend to strengthen the yen, some tend to weaken the yen, but on balance I think your conclusion was that the Japanese policies have tended more, especially this year, to support the yen. Is that correct?

Mr. **Niskanen**. That is correct.

The Japanese both in their capital controls and in their exchange rate actions, have generally tried to support the yen when it is relatively weak, and to weaken the yen when it was relatively strong, to try to stabilize the value of the yen.

Several rather contrary suggestions have been made by elements of the business community about what we should encourage the Japanese to do with respect to their capital controls.

Some people have suggested we ought to encourage them to control outflows of capital in order to strengthen the yen. Other people have suggested we ought to encourage them to move much more toward an open capital market, in order to induce others to use the Japanese yen as an international currency.

My sense is that the short-run effect of relaxed capital controls, in a world in which other people expect them to impose such controls at some future time, would weaken the yen.

If the Japanese moved in a way which was perceived to have a long-term effect in opening up their capital markets, you may have a short term effect to weaken the yen, but the longer term effect is that the yen would then be subject to some of the same kinds of pressures as the dollar, as being an important reserve currency for world trade.

Our policies, the policies of the administration, have been to try to induce the Japanese to open up both their domestic markets for goods, agricultural products and for services. Their major remaining restraints are on services and agricultural products.

If they relax those restraints, the short term effect of that action would be to weaken the yen, but I think it still serves our interests to do that, and that we should not let the yen rate itself dominate our policies. Our policies to encourage them to open up their domestic product and service markets as well as their capital markets I think are in our interests over a longer period of time, and I think ultimately are in their interests, but it may have a short run effect of weakening the yen.

Mr. **Pease**. Do you think it would be in our interests to encourage the Japanese to internationalize, if you will, their investments so that people can invest more readily and easily in Japanese instruments?

Mr. **Niskanen**. Yes, I think it would be. Japan is one of the largest generators of saving in the world, and I think it is in our interests to be able to borrow on the Japanese market and for Japanese savers to invest in the American market.

It is particularly important to us in a period of time in which we will have large Government deficits, and so I think that that is something we should in general promote.

Over a longer period, if they do that, it may have the effect of strengthening the yen.

Mr. **Pease**. Believing that, do you think we have any business encouraging the Japanese to move in that direction?

Mr. **Niskanen**. I think that we have a case to make that it is in our mutual interest to do that, to open up their capital markets.

Mr. **Pease**. It is my understanding that for the first three quarters of 1982 Japanese foreign exchange reserves dropped by about $4 billion.

On page 39 of a USTR report, "Japanese Barriers to U.S. Trade," it is stated that "In 1981 overseas yen lending in yen bond issues by foreigners were around $4 billion."

Do you feel that these two actions serve to offset each other in terms of their effect on the strength or weakness of the yen vis-a-vis the dollar?

Mr. **Niskanen**. Yes, more or less.

The reduction in their reserve position reflects an intervention by the Japanese Government to strengthen the yen. Our borrowing over there would weaken it.

Mr. **Pease**. What do you think, if anything, the U.S. Government ought to do about the currently large trade imbalance with Japan, an imbalance that we were told this morning will grow a great deal larger?

Mr. **Niskanen**. I think that in general it is inappropriate to target policies on trying to reduce or increase bilateral balances either in merchandise or in total balance. It is important to recognize, for example, that we have a net trade surplus with respect to Europe not quite as large as our net trade deficit with respect to Japan, and we have to recognize that we live in a world in which everybody is watching our actions, and I think that it would not serve our interests to take actions to reduce bilateral deficits with respect to any particular country.

There are exceptions to that.

When you are dealing with countries with an inconvertible currency, such, for example, as the relationship between Finland and the Soviet Union, they have to be very concerned about bilateral balances in that case because an accumulation of ruble balances is of little worth, but in a world in which most trade is conducted between countries with convertible currencies, a concern about bilateral trade balances itself I think is an inappropriate basis for policies.

Mr. PEASE. So you would say that we should not be concerned, no matter how large it gets, $40, $50 billion?

Mr. NISKANEN. With respect to any one country again, unless you have a convertibility problem or in some cases a national security problem in trade in particular products.

Mr. PEASE. How about if you have a political problem?

Mr. NISKANEN. We have a political problem in the United States for all kinds of reasons, but I think that the presumed under-valuation of the yen is the least of those problems.

Mr. PEASE. How about the apparent obvious trade imbalance with Japan? What if that becomes more of a political problem than it is, if it leads to growing protectionist pressures?

Would you stay the course nonetheless?

Mr. NISKANEN. My sense is that there is not one American in a thousand who has the vaguest idea of what those balance of trade numbers are.

Mr. PEASE. You come up to my district and I will show you more than one in a thousand.

Mr. NISKANEN. They care whether they have a job and they care what their sales are as a businessman, and it is no matter I think that we should address.

Mr. PEASE. Sir, I hate to disagree with you, but if that is the policy of this administration, I think that we are in for very, very serious trouble, and that the protectionist pressures which the President worries about are going to overwhelm the Congress.

I just spent several months traveling all around my own congressional district in Ohio talking with people, and they are acutely aware of the trade imbalance with Japan, and it is that trade imbalance which is used more than anything else as a reason why I should support protectionism in legislation.

Now, to say that not one person in a thousand is aware of that is patently ridiculous, at least as far as my own congressional district is concerned.

Chairman GIBBONS. It is not only the trade imbalance, but it is the perception that the Japanese market is not open to us on the same type of basis that ours is open to them.

Mr. LAWSON. I think that is correct, Mr. Chairman.

If I may weigh in here on that point from our perspective, the issue is not so much in the trade deficit per se, although that is a matter of great concern to us. The trade deficit is not the whole problem; it is rather like a barometer of the barriers that Japan has erected to U.S. efforts to penetrate their market.

The basic issue here in our trade relations is one of market access, and it is our view that if these barriers were to be brought down that the trade deficit could be reduced. Now it is impossible for anyone to sit here and say that it could be reduced by half or 40 percent or 30 percent, and we won't know until these barriers are reduced, but we ought to try to reduce them, and that is what we have been doing these last 2 years.

It has been slow going. We have been slogging away. We haven't made as much progress as we obviously wanted to make, but we are acutely aware of the pressures in the country here—in the Congress, by the average man in the street, by the private sector—to gain greater market access into Japan, and that is the principal objective of our administration.

Mr. **Pease**. What about, since you brought that question up, the examples we heard this morning of Caterpillar Co. trying to sell its equipment in Saudi Arabia or elsewhere against Japanese companies when, according to them, there is a price differential of 18, 20, 30 percent? There are no barriers in Saudi Arabia to our products being sold, and yet we can't even come close. Caterpillar acknowledged to be one of the best-managed companies in America, can't come close. You can't attribute that to trade barriers.

Mr **Lawson**. No, that is not a trade barrier, but that once again takes us back to the yen/dollar fluctuation.

Mr. **Pease**. But the administration, I understand, is saying it does not see a serious imbalance and it does not intend to do anything, whatever marginal imbalance might exist; is that correct?

Mr. **Lawson**. Well, to the extent that the issue of Caterpillar being undersold consistently in Saudi Arabia or elsewhere in the world is really sort of a profit margin issue, it is strictly speaking not a U.S. Government problem. If we have lower government deficits and lower interest rates, we ought to in turn see less overvaluation of the dollar and make our products more competitive in the Third World. But again, this is the yen/dollar problem that we are facing right here, and we do not think that it has a significant impact on the trade deficit.

Mr. **Pease**. One last question, Mr. Chairman, of these administration witnesses.

This morning we were told by Mr. Peterson about a publication, a bipartisan appeal to the President of the United States and to the Congress, from five former Secretaries of the Treasury, and Mr. Peterson, is a former Secretary of Commerce, for fiscal responsibility as a way of bringing down our deficits and helping to erase these disparities in the values of U.S. and other currencies. They seem to think that we can't do it by cutting domestic programs alone, and we have to also cut defense, at least cut the rate of defense spending, and increase taxes as a package, along with domestic cuts, in order to provide some stability and prove to the capital markets that we really are serious.

Has the administration made any progress at all in moving toward that direction?

Mr. Niskanen. I think that the best statement of that will be in the budget presented in January. I am not in a position to pass judgment upon the appropriateness of most of the elements of the budget.

I do think it is important to get the deficit down, for various reasons. One should not expect too much from that, however.

The Japanese, for example, have been running government deficits of about 5½ percent of their GNP during this same period of time that the yen has been unusually weak, and so reducing our deficits may be very helpful in a number of ways, but by itself one should not count on that being the solution to the perceived exchange rate problem. I think that it may very well help.

Also, I think that we are very likely in a period of time in which there is an unusual amount of political uncertainty around the world—I think that uncertainty is being resolved, and is likely to be resolved as it becomes clear who the Government of Japan is going to be, and what they are going to do, and who will be the new Government in Germany after the March elections.

There has been an unusual uncertainty about the behavior of some of the major developing countries concerning their international debt situation. My guess is that those uncertainties will be resolved somewhat over the next several months, as I think they have been.

I think that the weakening of the dollar by about 2 to 3 percent since early November reflects a partial resolution of some of those uncertainties.

Mr. Pease. I have one last question. This is a little bit off the mark, but just as a matter of historical perspective I guess.

I would be curious to know, sir, how long have you been on the Council of Economic Advisers?

Mr. Niskanen. April 1981.

Mr. Pease. 1981. So you were there in August 1981 when we were told that when the President's economic recovery package was passed, the deficit would be zero in 1984; is that correct?

Mr. Niskanen. I believe there were statements to that effect.

Mr. Pease. It was a published document.

Mr. Niskanen. Yes.

Mr. Pease. It wasn't just a statement, it was published documents.

Mr. Niskanen. I don't recall them exactly. I do recall projections of that nature in early 1981, but I presume that that is correct.

Mr. Pease. Is there any way that we can fairly hold you responsible for the disparity between projections and reality?

Mr. Niskanen. One of the blessings of my particular job is that I do not have responsibility for the forecasts.

Mr. Pease. I would certainly hope that you raised a lone voice of reason within the administration when those figures were being peddled to the public. You are nodding your head. I am glad that you were.

Mr. Niskanen. In retrospect, I think that there were two reasons why those projections proved to be far too optmistic. One is that the recession turned out to be longer and deeper than anyone expected. Then, and even until last spring, most people were expecting the recession to end rather quickly.

Second is that there was a judgment by some people, that was not broadly shared, that the favorable effects of cutting tax rates would occur over a much shorter period than what most people expected. I think that those expectations are now generally recognized as being inappropriate.

Mr. **Pease**. Delicately put.

Thank you very much.

Chairman **Gibbons**. I have spent some time looking at who we are buying from and who we are selling to, and I agree with you thoroughly. We should not try to have a precise bilateral balance around the world with everybody. That is ridiculous, because we trade for those things that we can best buy on another market or best sell on another market.

What worries me is that I see us running a surplus with what I think is a weak sister, the European Community. Their policies are suicidal. They are going to go busted, belly up over there, if they don't change their course sooner or later.

They are subsidizing agricultural policies and dumping sugar on the world market for one thing. They have dumped butter. They have dumped everything else, and there is no way that society is going to survive in the future. They are going to slowly sink into bankruptcy, and they are our best customer.

Other good customers are the real poor undeveloped countries. I am afraid they are getting all their money from the international bankers, so it looks like we are paying for their goods through our credit policies.

Then our next or third best customers are the Communist countries. I certainly can't think that communism is the wave of the future as far as the economic policy is concerned, so I am concerned that we really have some weak customers out there. We have the Europeans with their "spread the misery around, let's all go broke together."

You have the lesser developed countries that are borrowing all the money that they are using to buy our goods with, and you have the Communist countries that are our best customers. As a fellow that is interested in the future, I think we are kind of betting in the wrong direction.

Then to see our currency appreciate against everybody's currencies as it has leads me to believe there is an awful lot about currency that I don't understand, but that is where we are in the world economic picture as I see it now. Am I wrong?

Mr. **Niskanen**. I think you have a legitimate perceptive concern in this regard. We have a concern about basically the portfolio of our customers.

Chairman **Gibbons**. Yes.

Mr. **Niskanen**. And we wouldn't want all of our customers to be subject to the same kinds of threats or even different kinds of threats at the same period of time. I am less pessimistic I suppose than you may be about Europe.

I think our primary trade concern with Europe is with respect to their very large agriculture subsidies, and that is something that we should aggressively press over a period of time. I am moderately optimistic——

Chairman **Gibbons**. We have been pressing it ten years, 12 years that I know of, and maybe longer.

Mr. **Niskanen**. I am moderately optimistic about resolving that issue if we have patience, primarily because there are internal tensions within the European community concerning that policy. It is basically a north-south dispute on that policy, and I think that there may be ways to operate, to use that tension internal to the community, to get them to resolve that, but the concern is wholly legitimate.

We should also expect, as you suggest, that we are not going to be selling a lot more to the developing countries the next year or two, until they get their financial situation in order, and the only way they are going to be able to do that is to import less or export more, and that can have repercussions back on us that are not in the short run favorable.

Mr. **Lawson**. May I just add my thought here? I am head of trade for East Asia, and in that region there are several newly industrializing countries—Korea and Taiwan and the ASEAN countries. The ASEAN countries—Singapore, Thailand, Indonesia, the Philippines, and Malaysia—are the fastest-growing trading partners we have in the world.

Chairman **Gibbons**. I would bet in their direction. I think they will be strong.

Mr. **Lawson**. Their economies are on the upswing. They have a lot of natural resources. They have the manpower and technical expertise. They like and want U.S. technology. We ought to target, as we have been in the last couple of years here, our export opportunities toward those countries.

That is what we have been doing in the Department of Commerce—to encourage more and more of our small to medium-sized companies to become acquainted with the ASEAN countries and learn their markets, do their homework, and get out there and sell. I think that could be one bright ray of hope here.

Chairman **Gibbons**. I find, as I go to the ASEAN countries, that while most of them were occupied by Japan in World War II, they are buying the Japanese products left and right. The Japanese are out there selling and making deals a lot faster than we are.

I agree, those are excellent potential markets, but I am afraid we are being outgunned there.

Mr. **Lawson**. We are for the time being, but I think with the export trading company legislation just passed, we are now going to have in our arsenal one of the tools the Japanese have been using so effectively in the last 20 to 30 years.

I would expect us to improve our effort and our performance out there.

Going back to Japan, if I may make one little last comment here, we have made the point to Japan over and over again that because their economy is so vigorous, they ought to step forward and liberalize and make international trade more respectable again.

While it is hard to come up here and preach patience, I think that is what the doctor has ordered, although I can well understand and sympathize with the feeling of many Americans that our patience is running out.

Chairman GIBBONS. I think Mr. Pease has a good point. I think nobody doubts my commitment to a market-oriented system of trade; but unless we see some real results, unless some of the things I have referred to here about Japanese practices are changed, I am going to be overwhelmed; and so are the rest of us in this Congress.

Mr. NISKANEN. Mr. Chairman, a number of policy suggestions have been made in the course of this hearing by earlier witnesses that I think we should comment on. I think the idea of an import surcharge with respect to Japan or any currency that is presumed to be undervalued would be a very dangerous measure.

It is in clear violation of at least two of the major rules of GATT; and in addition, it would seriously hurt our exports to Japan. I think our GATT arrangements are very important to us over a longer period of time; they have become increasingly fragile.

I would be very concerned if we took an action that would be such a clear violation of them. It would also not be in the uniform interest of the United States alone. An import surcharge with respect to Japan would help some of our import-competitive industries but would hurt our exporters.

I would advise strongly against that kind of policy.

Chairman GIBBONS. Let's just talk about the Japanese. You know, we could sell them lumber, but they will buy logs. We could sell leather, but they buy hides. We could sell fertilizer, but they buy rock, just to mention a few things.

When I met with the salt and tobacco monopoly over there, they had the gall to tell me the Japanese didn't like cigars. Well, who would like cigars? You could buy them here in the U.S. market for five of them for 63 cents, I think. It is all in the record.

They were selling them over there at about $4. Sure, no Japanese is going to smoke a cigar. I don't smoke them, either. It is not because of price. They had the gall to tell me the Japanese don't like cigars, so they charge $4. My manufacturers said they will sell to the Japanese at the same price they sell to the Washington distributors, deliver them over there.

Every year, my citrus people come in. About Christmas time, the Japanese find a new insecticide they don't like. We end up with grapefruit, oranges coming out of our ears sitting in Yokahama. It happens. It is going to happen this Christmas time. I know. It always happens.

They finance the Liberal Democratic Party out of a slush fund they generate off of oranges, from the kickbacks they get from the orange salespeople over there. I don't believe them. They can do a lot better. They are going to have to do better.

Mr. NISKANEN. You are entirely correct in that regard.

Chairman GIBBONS. Then they come up with this phony deal on the bicycle-motorcycle races over there in which they plow about $1 billion worth of subsidies into the machine tool industry and claim it didn't even exist.

Mr. NISKANEN. You are entirely correct in that regard. I think we should continue to press them on a wide range of those things.

Chairman GIBBONS. No sensible Japanese is going to buy our car because the steering wheel isn't on the correct side for them. But we send our cars over there. They tear them all apart getting them through the customs inspection. We take the Japanese manufacturers' certificate and land their cars here. It is a paperwork thing.

Over there with the car that they don't even want and was never competitive, they make a mammoth case out of it. They have to change their practices. They have had enough time since World War II to change.

If not, I am telling you what happened in 1930 with Smoot-Hawley is going to look like child's play. I will go down voting against it, but it is going to happen. The protectionist pressures keep building up in this House of Representatives, and building up.

It is a shame to destroy all of the good that has come from a system that works; but the Japanese are committing aggression against us in this regard and they have to stop.

Ms. CONSTABLE. Mr. Chairman, may I comment on that issue?

Chairman GIBBONS. Yes.

Ms. CONSTABLE. I think one of the points some of us were trying to make is if you look at the yen-dollar relationship and look toward the effects of appreciation of the yen, clearly that would ease the problem for the moment, but it would not address some of the other structural problems.

Chairman GIBBONS. I know, but I don't have any faith—their reserves may be 10 times higher than they have been. We are taking their figures on their reserves. I don't trust them. I have lost my confidence in them.

Ms. CONSTABLE. Well——

Chairman GIBBONS. They could hide those reserves as easily as they could hide anything else. We don't know they haven't.

Ms. CONSTABLE. I would be inclined to always be somewhat skeptical about any international figures.

We do believe in this case the data does suggest——

Chairman GIBBONS. How do we know their reserve figures are accurate? We take their figures.

Ms. CONSTABLE. If I may make another point and perhaps come back to that, the only point I wanted to make is that on the trade side we have to do more on the market access question.

We have not succeeded in solving that problem; and the Government of Japan must take further actions.

In fact, a team left for Tokyo this morning to continue discussions with the Government of Japan on a number of issues related to market access.

Chairman GIBBONS. You know, in 1970 I was impressed by that. I haven't seen much change. This is 1983 almost.

Ms. CONSTABLE. There have been some things done.

Mr. LAWSON. I would have to say I agree with you in your statement that Japan must change its trade practices now.

Secretary Baldridge just made that point again a few days ago.

I think we have an opportunity now with the new government in Japan to make some of our points again in very clear language. We are doing that at the present time. We are making it very clear to the Japanese that there must be certain changes in their trade policy because protectionist sentiment—in the Congress, in the average man on the street, the private sector—is building up.

It is going to be very difficult in this administration to continue coming up to the Hill and saying that no, no, the best way to handle our trade problem is not to exclude Japanese products, but to open up Japanese markets.

However, that is our current policy. I think we need to have a little bit of time here in order to educate the new Japanese Government in what we require.

Chairman **GIBBONS**. You don't need any time to educate them. That is the same government with a new Prime Minister. I have been going to that country since the early 1970s. Nobody has changed over there. They are a hell of a lot more consistent about personnel people than we are. We have had so many USTR's since I have been here, even as close to it as I have been, I can't name them all.

The same thing with all the other economic people in our Government.

You know, every time we get somebody worth a hoot, they get a better job in private industry. That doesn't occur in Japan. They stay on and keep going. But you know, all of you fellows will be out in a couple of months or a couple of years.

We will be going back through this exercise again. I have seen it happen. The Japanese—you meet the same ones. They swap their portfolios around a little to kind of keep us confused about what is going on, but they are the same people over and over and over again.

Mr. **NISKANEN**. Mr. Chairman, I think there is some progress in the last several years, liberalization of market access in manufactured goods and liberalization in their capital markets. The major areas in which their domestic markets now are most strongly protected are in service and in agriculture, but I think we should not dismiss the movements that have been made in both manufactured goods and in their capital markets.

I think we have a basis for convincing them that it is in their interest over time to open up their services and agricultural markets as well.

The Japanese economy, I think, is somewhat like a crab: It looks hard on the outside, but it is soft on the inside. They have a habit, as we do on occasion, of protecting what they perceive to be their weak industries.

I think we should appeal to them with much the same kind of argument that we use to try to resist protectionist pressures here in the United States; that it is in their interests to open up those sectors of their service and agricultural markets that are still strongly protected.

Chairman **GIBBONS**. I am going to measure their performance very closely. There has to be an improvement in the beef situation. There has to be an improvement in the citrus situation. There has to be an improvement in the hide situation. There has to be an improvement in the lumber situation. There has to be an improvement in the fertilizer situation. There has to be an improvement in the automobile situation. There has to be an improvement in their financial markets.

They have to come in and carry their share of the burden of being the world banker and the world exchange, and they know how to do it. They are going to have to do it or we are going to have some disastrous results right here across the top of this table. There are not enough of us left in this Congress now to take the same kind of tolerant attitude we have taken toward the Japanese since World War II on their trade practices. It will not fly any more.

If it were voted on now in the Congress, you'd have a veto matter on your hands, and I'm not sure that there are enough votes to even sustain a veto.

So while I applaud what you are doing, I am just trying to tell you we have run out of air speed. We have run out of momentum. Now the problem is the Japanese. They have to change.

We are going to have more hearings on the yen/dollar relationship. The hearings today have raised a lot of important issues. I am going to instruct the staff right now to contact Mr. Volcker of the Federal Reserve and the IMF.

As soon as Mr. Shultz gets back, we are going to be talking with him. We may have another trip to Japan early next year. It won't be a peaceful landing over there either, I can tell you that. I know there will be a lot of Americans getting off that plane raising hell.

So this concludes the testimony for today. We thank you very much for coming.

[Whereupon, at 4:45 p.m., the hearing was adjourned.]

[The following was submitted for the record:]

STATEMENT OF ALLAN COSSENTINE, TEMPORARY SECRETARY-GENERAL, FEDERAL PARTY OF THE UNITED STATES OF AMERICA

SUMMARY

Because of our negative trade balance problems with Japan, they have found it necessary to make vast investments in our economy to maintain the value of the dollars which they have accepted from us. Incidentally this is also true of the Arabs. The effect of this is the lowering of the value of their currency. Therefore with the sagging of the auto market for both domestic and foreign cars, the Yen has to go down, which comparatively makes it easier for them to sell their products.

The answer is to set our own house in order, by providing 2.5 percent prime interest with the Federal Party's program for monetizing the bonds. The presentation makes other suggestions for production cost savings.

We would then not have to go hat in hand to Japan, to ask her to voluntarily restrain her imports. When our lowered costs justify it, we can then insist she lift all barriers to our products.

There are other things considered:

1. The Deficit. With the Federal Party's bond monetization program, there would be not deficit, in 1983 there could be over $100 billion surplus instead.
2. The Pothole Tax. Adding 5 cents a gallon to the gas tax would be counter-productive, costing more jobs than would be saved.
3. The MX Dense-Pak Plan. Wouldn't it be better to build up anti-ballistic systems than to build more weapons when we have enough already. The Federal Party has never seen any sense to banning ABM systems.
4. The Fossil Fuel Problem. We must begin to base our transportation modes on hydrogen, not hydro-carbons, else we will lose our environment much more surely than from nuclear bombs.
5. Gas Pipe Line Policy. The Reagan administration's meddling with the Russian gas line project was not only counter-productive to our interests, but was, we feel, generated by the banking interests which control or are controlled by Western oil cartels, including OPEC.
6. Hemispheric Affairs. Apparently we can not trust the governments of Latin America to perform justly. Since 1823 we have assumed responsibility for this hemi-

sphere. As a result, we may find ourselves openly responsible for tyrannies that exist.

7. The Inflation Bugaboo. There is a difference between disbursement and lending. Contrary to what Mr. Volcker tells you, making reasonable credit available to the public will NOT create inflation. It will, instead, cause such a surge in the making of products and services that everyone who wants to will work, thus bringing the costs of government down which will further bring down prices. The Federal Party's monetization program will produce this condition.

STATEMENT

Mr. Chairman, Honorable Members of the Sub-Committee on Trade, Ladies and Gentlemen, I thank you for inviting me to appear before your committee, and I wish to present the position of the Federal Party of the United States of America on the question of trade policy between nations.

We have the problem of watching our domestic markets disappear into the hands of foreigners who seem to be able to come up with better products at lower prices.

The problem is not to be laid at the door of our foreign friends. It is a natural result of our own fiscal policies which have been ignored by politicians and economists alike.

The Federal Party has been advocating the monetization of all interest-bearing bonds issued by the U.S. Government. The remarks that follow give only some of the reasons why this should be done so that we can get our production facilities back on the track.

We have been used to being the leading commercial power in the world for a number of years, but lately the scene has changed.

As a thing new for the United States, we have the novel experience of watching our dollar not so slowly sinking at times in the foreign markets. This is what is known as natural devaluation of our currency. The net effect of devaluating any country's currency is to make its products cheaper to export and this, in turn, supposedly helps the balance of payments. But what is sometimes forgotten is that it also makes imports more expensive and thus the balance of payments receives no help at all. The reason for the fall of the dollar on foreign markets is basically that our imports far exceeded our exports, due mainly to the oil import situation.

There is no artificial way to alter oil prices downward except by the old law of economics—supply and demand. It would be far better to set up inducements to our energy-supplying companies, which now deal almost exclusively in petroleum energy, to cause them to seek sources alternate to the use of fossil resources in the production of liquid energy. This would force down oil prices since there is no loyalty among those who would hike oil prices for the sake of making more money; therefore, the lessening of demand in our country would have a ten-fold effect on the world demand for oil.

By reducing such a demand, we could also force down the prices of oil with attendant benefits of less risks from oil spills, and other accidents in connection with its shipping. The Federal Party would have no shrift with any so-called internationalist who complains that the U.S. has six percent of the world's population, but uses a highly disproportionate share of the total of the world's energy because the Federal Party would remind such a person that this same six percent of the world's population produces 90 percent of the world's food grains, 60 percent of the world's technology and 40 percent of the world's industrial output. And even though the steel industry is in a slump, it still produces a disproportionate share of the world's steel output. We have mentioned before the cures which the Federal Party suggests for the steel industry situation, but we mention that only in passing while we approach the subject of dealing diplomatically with the problem of excessive imports.

We are referring mainly here to a very good business partner that we have in Japan. Japan has a need for a large amount of imports of many things that we can furnish. But, because of our own domestic fiscal policies, we have allowed Japan to outstrip us in production efficiencies. The Federal Party feels that it is unfair for us to ask Japan to unilaterally strip herself of her markets in our nation in an artificial manner. The Party feels that it would be far better to reduce the costs of our doing business in the areas of capital costs, feather-bedding excesses, and the overbloat of government.

The Federal Party feels that with the availability of all the capital represented by the interest-bearing bonds of the government, it would be possible to reduce capital costs down to where refinancing of worn-out factories could be done. We feel also that the removal of any type of compulsion causing laborers to join unions against their personal wishes would result in a very much lower cost of production. Not because of any resultant lowering of wages, but because of the self-setting of the union house in order as a result of giving union members the ability to control their own futures in a self-determinate manner. The resultant flight of racketeers from union organizations would in itself be a tremendous production savings, and thus would make American industry able to compete with any other national industry on this planet.

But even more so, the trimming of the Federal budget by at least two thirds of a trillion dollars would result in such tax savings to American industry that with our well-known ability for efficient operations, we could turn our trade balances around and also eliminate unemployment as a relevant factor in our lives.

Now, wherever Japan, or any other nation has set up any discriminatory barriers in order to give artificial protection to her own industries—to these barriers we would have a legitimate right to object. But in all fairness, we have no business asking her to limit her exports to us on a voluntary basis simply because we are in danger of floundering financially because of her efficiencies. The Federal Party proposes that immediate measures, as suggested earlier in this chapter, should be taken and if a majority in Congress can be had by the Federal Party we commit ourselves to take these measures immediately. As Roger Babson in his book "If Inflation Comes" humorously suggested, the big lesson to be learned is that if you get into a war and lose it, and become entirely conquered and devastated, as a result, you can then abrogate all previous obligations, get rid of all restrictive policies which made your government inefficient enough to lose the war, and start all over again, which will soon put you in a position of outstripping your former enemies. By getting rid of these costs you can actually force your former enemies to make you prosperous because the products which you now offer are not only cheaper, but actually superior because you are no longer bound by previous obsolete technologies.

However, The Federal Party submits that it is still possible to accomplish all these things while still in peace time, and by so doing obviate the necessity of getting into war. The Federal Party would wish to burn into the reader's mind again by repeating the solution to our depressed industries is not asking competitors to relent in the pursuit of business, but to get on with the business of monetizing the bonds, freeing the unions, and reducing Federal spending by at least two-thirds trillion dollars. The Reagan program, while pointed in the right direction, has infinitely less thrust than is needed. A program that will be effective in saving our economy will have to be as big as is suggested by us elsewhere.

Japan has put up barriers to the importation of our automobiles, and some of our electronic products. which barriers have become rapidly irrelevant because of the fact that our production costs are too high anyway. To ask her to voluntarily reduce her exports is an unacceptable admission on our part that we cannot compete. The Federal Party contends that we can compete, and shall compete.

The Federal Party does not believe for one moment that everyone in this country will agree with all of our concepts. But there are several opinions which we hold, to which only the most treacherous and self-destructive subjective theorists would disagree.

Item No. 1. The Deficit. The law of diminishing returns is nowhere better demonstrated than in our economy. As the economy slows, the income of the government is getting smaller and smaller. But yet the demands from those who are hurting grow larger and larger and thus the deficit grows by leaps and bounds. The deficit which was supposed to disappear by 1984, will probably reach $200 billion during 1983. And yet no one in or out of government has the slightest idea of what to do about it.

We are reminded of an allegory concerning monkeys in the jungle who, although they had watched humans build a bonfire, could never get the hang of the fact that to keep a fire going you have to put wood on it. The experimenters even left a pile of wood handy and after demonstrating to the monkeys the art of throwing wood on the blaze, withdrew to observe. While the fire was high the monkeys would form a ring around it and dance happily and noisily until it started to fade, when they just stared sadly at it and whimpered with the returning cold. The solution to their need was stacked up ready to use, but they never could get the idea. So the fire eventually went out and the monkeys mournfully departed and the night was silent. Unless the Federal Party's program of monetizing the bonds is set in place, soon, thus making $1.25 trillion available to the private sector for economical capitalization of our needs, our Republic with its beautiful freedoms and opportunities could still whimper its way down in the maelstrom of tyranny.

Does this mean that the politicians running our government are monkeys? Not exactly, since the monkeys had the good sense to leave the situation. Politicians keep crowding in, messing it up more and more.

Let's be optimistic and say that the deficit in 1983 won't go over $165 billion. Now if you subtract the $137.5 billion interest bill from the deficit you still have a deficit of $27.5 billion. But if the economy surges from an abundance of reasonable capital and if, as a result, unemployment down 8 percent, then the government would be looking at a $172.5 billion surplus. With this we could put Social Security back on the track and keep it there, we could fix all the potholes and creaky bridges in the country, and we would have money enough left to build a sensible defense, not just a fashionable one.

When the Reagan tax cuts were put forward, it was with the idea that the money saved would be the foundation of renewed business activity. What everyone forgot was that tax cuts without matching budget cuts merely increase the deficit, causing interest rates to go up and leaving everyone worse than ever. What was the difference in John F. Kennedy's time? Simply that the prime interest rate went up as a result, but not more than to 9 percent. This was still manageable at first, but soon the effect took over and except for the shot in the arm provided by the Vietnam war effort, many sectors of business were soon seeing their financial parameters closing in on themselves.

But even more than that is the problem of Stockman and Co. trying to make their budget cuts off the backs of the poor who don't have it too good anyway. The Federal Party declares emphatically that just because money can be saved by squeezing down on the needy and unfortunate is no reason for doing it! With reasonable capital once again available, no one class need be penalized again.

Item No. 2. The Pothole Tax. The idea of placing a 5 cents per gallon surtax on gasoline may at first blush have some validity for the purpose of fixing up deteriorated roads and bridges, but the Federal Party warns that this will only alleviate at the most about 1/30th of the unemployment problem. But this could create even more in the way of economic problems. If businesses find themselves laying off additional workers because of higher transportation costs—what good will be done? The Federal Party's plan for producing low cost capital will enable local governments to fill their potholes without hiking anybody's load, and the Federal government will have the income with which to fix up the interstate system. The current plan will not provide as many jobs as contemplated because unless you are going to hire coolies to carry dirt in baskets you will not provide jobs which are better done by modern road-building equipment. The only sensible way to do a road re-building program is to seek out the most efficient contractors who, with their big machines don't need that many workers.

And watch out for another thing. The publicity drummers for the whole idea are including suggestions that some of the new tax money will be used for the rehabilitation of "public" transportation. This would be a scabrous violation of the user tax principle. With low-cost capital as suggested by the Federal Party the "public" transportation companies could restore themselves at no cost to the public.

Item No. 3. The MX Dense-Pak Plan. The new idea about the MX basing is founded on the concept that the Russians would send over two or three missiles tentatively testing the Dense-Pak field which would make it impossible for them to get any other through because of the resultant radiation and debris. But if we understand paranoid schizophrenia correctly, the Russians would not send two or three missiles against Dense-Pak. Since they literally have thousand of missiles to send (as we do) their cunning would have them send a couple of hundred at once and then they would not need a second salvo. One other advantage, this would minimize the total damage to the rest of our country; meaning that a big portion of our population would remain alive to be enslaved by the communist system.

We don't want to fall into the trap of Maginot Line thinking but we have observed that laser technology is on line which could make it possible to control any and all objects in the air or in space. The one big single requirement for this program would be massive electric power. The commintern knows this and now you have the formula for understanding all the anti-nuclear brouhahas which have occurred all over the world, except in Russia. The Soviets have been building nuclear powerplants as fast they physically can, and the Federal Party is under no illusion that all this power is for their citizenry. We believe that money would be better spent for developing laser attack methods which destroy missiles before they even start their trajectory. But we also think that for now enough has been said on this subject.

Item No. 4. The Fossil Fuel Problem. There are a number of reasons for dispensing with the use of fossil fuels in our economy: international entanglements, pollution of beaches and landscapes, pollution of the air, destruction of our water sources and bodies through acid rain, the production of carcinogens (cancer causing elements) a long way beyond that of any nuclear program, an average of 250 deaths a year in the production of fossil fuels and finally, the pejorative changes in the weather by the fossil fuel effluents.

The obvious target for new efforts is the use of hydrogen for fuel in cars and factories and eventual use in airplanes. Literally, then we could all see things a lot more clearly. The Federal Party believes strongly in the policy of individual wind generators for each home which would serve to release the present generating facilities for providing clean electric power for factories and electric cars, thus cutting down on the acid rain peril, which is even more scary than the Russians.

Item No. 5. Gas Pipe Line Policy. Speaking of the Russians, the Federal Party has not been in agreement with the Reagan policy of trying to sandbag the Russian gas sale agreement with Western Europe. The thought that the Russians could use choking off the supplies of gas as a political maneuvering mechanism is more than offset by the flow of hard currency into the Russian economy, thus making them equally dependent upon European good-will. As the effect of this money is felt throughout the body politic of Russia and as the non-white population of Russia observe the increasing disparity between themselves and the White Russians around the Moscow area, communism may well collapse of its own weight. In fact, the Federal Party has good reason to believe that it will anyway. While natural gas is not the fuel of ultimate use, it is still cleaner than oil or coal. The United States should never have been painted into that corner, and we can not help but believe that the banks controlling the fossil fuel industries of the West were behind this goofup.

Item No. 6. Hemispheric Affairs. The Federal Party feels that all who have responsibilities should be strictly held to those responsibilities. How, we ask are you going to help any people in their struggle for equitabilities if you insist on playing footsie with the repressive elements in that country? Again, how are you going to convince any people of our sincerity when our past policies have only resulted in the rise of Somozas and Batistas, etc.? We have only ourselves to thank for the presence of Castro & Co., but at least Fidel is no hypocrite and he stands right where he says he stands. But in dealing with official governments in El Salvador, Panama, Guatamala etc., you have no idea with whom you are dealing. The Federal Party feels that when we set out to aid any of our neighbors to the south we should make very sure that the aid really arrives at the names of the compesinos and that it does not end up as Mercedes cars for corrupt politicians. The Federal Party will not overturn truly elected governments, but it will reserve the right to summarily punish the depraved beasts at the head of the Paraguyan government, for instance. And the first priority of the Federal Party will be the building up of adequate forces for this purpose. We feel that if these forces are present and ready they may never have to be used.

The spectacle of the Mexican Peso falling so precipitously is the result of capital flight towards the U.S. because of our interest structure. The Federal Party's program of monetizing bonds and thus reducing prime interest to a reasonable level would be a great stabilizing factor in the Mexican economy. We would then be able to go back to "trade, not aid". Incidentally, this would help solve many of Western Europe's problems as well, with reasonable capital once again available there as well as here.

Item No. 7. The Inflation Bugaboo. We have become more and more convinced that there is a conspiracy to keep things like they are. Mr. Volcker tells Congress that if you loosen credit, the common people will have too much money and then inflation will rise again at an untenable rate. So how do you fix it? Very simple. You merely sterilize the common people financially and then you bring inflation under control. What not even Federal Reserve people seem to understand is that inflation has two legs—scarity and cost of doing business, with the later leg usually giving rise to the former. Reduce the costs of doing business and manufacturing—scarcity will not be a problem. Remember what we have said about the costs of doing business? So why not first monetize the bonds and cut down on capital costs by causing the prime to drop to 2.5 percent, and then reduce the Federal government's budget by at least $350 billion so as to further reduce business costs? We'd then have the money for the things we as a nation are morally obligated to do—like setting Social Security back on the track without having to sand-bag anybody. The Federal Party does not feel that because privileges are aged, they are sacro-sanct. The tradition of interest-bearing bonds, MUST BE STOPPED. Otherwise we are going to see ourselves going hat in hand to other nations to borrow money because our economy does not generate each year enough to cover the deficits coming up, to say nothing of lending money to the private sector of our economy for production purposes. We will then, heaven forbid, have a foreign debt with no way of paying it, just like Poland.

Ladies and gentlemen of the Sub-Committee on Trade; if you love your country, if you love your salaries and perks, you must put the Federal Party's program into effect, or as sure as little green apples will be born somewhere next spring, you'll lose them.

The Federal Party thanks you respectfully and deeply for this opportunity to appear before this honorable body.

STATEMENT OF DAVID J. STEINBERG, PRESIDENT, U.S. COUNCIL FOR AN OPEN WORLD ECONOMY, INC.

(The U.S. Council for an Open World Economy is a private, nonprofit, public-interest organization engaged in research and public education on the merits and problems of developing an open international economic system in the total national interest. The Council does not act on behalf of any private interest.)

I welcome the Subcommittee's inquiry into the extent to which the over-valuation of the U.S. dollar in relation to the Japanese yen creates disadvantages for U.S. competition with Japan. I do not feel, however, that this issue can effectively be addressed except as one component of a coherent, cohesive, comprehensive strategy that addresses total U.S. economic relations with Japan in the context of a new strategy addressing total U.S. economic relations with all the industrialized countries.

Durable correction of the substantial distortion in the dollar-yen exchange rate is achievable only through an initiative that makes such reform one component of a dramatic, definitive, free-trade strategy aimed at (a) programming the removal of all barriers on international commerce and investment by the industrialized countries in accordance with a realistic timetable, and (b) securing a fully equitable code of fair international competition, including equitable monetary standards. A totally free-trade strategy (which I have advocated in many presentations to your Subcommittee) would impel, indeed compel, total (as distinct from patchwork, incomplete) reform of the rules of fair international competition, including correction of major distortions in the exchange rates of the world's major currencies. No other trade strategy is capable of such reform. Totally free trade and totally fair trade must be seen as one objective, indivisible.

I have the same misgivings (communicated earlier to your Subcommittee) concerning highly touted U.S. efforts to get international negotiations on services, high technology and other subjects not adequately covered by current agreements. Efforts on these issues, and efforts to secure freer U.S. access to Japan and other foreign markets, are today a policy hodgepodge not calculated to accomplish much. In fact, the predictable frustrations on each of these disjointed fronts could well fuel protectionist reactions whose terrible implications for the U.S. economy and the world economy should be clear to all knowledgable observers.

The policy stategy I advocate will confront extremely difficult challenges both in its foreign-economic and domestic-economic dimensions, including formidable problems of political palatability at home and abroad. But, properly designed and suitably orchestrated, it can succeed.

What our Council proposes is not currently endorsed anywhere in the Administration, the Congress or even in the "liberal trade" community. We persist in urging it because we believe it is the right course at the right time. The more timid, but no more realistic despite their protestations of pragmatism, will in due course awake to the urgency of this trade strategy whose time has come.

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